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BEFORE THE ARIZONA CORPORATION CO

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COMMISSIONER

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	Docket No. E-01345A-11-0224

NOTICE OF FILING

The RESIDENTIAL UTILITY CONSUMER OFFICE ("RUCO") provides notice of filing the Surrebuttal Testimony of Robert B. Mease and Lon Huber, in the above-referenced docket.

RESPECTFULLY SUBMITTED this 21st day of July, 2014.

Daniel W. Pozefsky
Chief Counsel

AN ORIGINAL AND THIRTEEN COPIES
of the foregoing filed this 21st day
of July, 2014 with:

Docket Control
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Phoenix, Arizona 85007

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ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-11-0224

SURREBUTTAL TESTIMONY

OF

ROBERT B. MEASE

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

JULY 21, 2014

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EXECUTIVE SUMMARY

On June 1, 2011, APS filed an application requesting an increase in rates and for a determination and approval of a just and reasonable return. On May 24, 2012, by Decision No. 73183, the Commission approved a Settlement Agreement reached by most of the parties in the case. As part of the Settlement Agreement, the parties agreed to leave the docket open until December 31, 2013, for APS to file a request to adjust its rates to reflect the rate base and expense effects associated with the acquisition of SCE's interest in Four Corners Units 4 and 5, the retirement of Units 1, 2 and 3, as well as any cost deferral authorized in the Commission's Decision in the Four Corners Acquisition Docket.

On December 30, 2013, APS purchased SCE's 48 percent share in Units 4 and 5 and now request that the Commission approve a Four Corners rate rider to permit recovery of $62.52 million annual revenue requirement. (On May 17, 2014, the Company provided updated schedules and their request increased to $65.43 million) The revenue requirement reflects the cost associated with APS's acquisition of SCE's share of Units 4 and 5, the retirement of Four Corners Units 1, 2 and 3, and for the deferred costs authorized in Decision No. 73130.

On June 19, 2014, RUCO filed direct testimony and proposed a reduction in the revenues that APS had requested from $65.43 million to $49.20. RUCO continues to propose a reduction in revenues of $16.23 million.

INTRODUCTION

Q. Please state your name, position, employer and address.

A. My Name is Robert B. Mease. I am Chief of Accounting and Rates employed by the Residential Utility Consumer Office ("RUCO") located at 1110 W. Washington, Suite 220, Phoenix, Arizona 85007.

Q. Have you previously provided testimony regarding this docket?

A. Yes. I filed direct testimony on this docket on June 19, 2014.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony will address the Company's rebuttal comments that pertain to adjustments I recommended in my direct testimony.

RUCO'S PROPOSED ADJUSTMENT

Q. Can you please explain the adjustment(s) that RUCO recommended in its direct testimony?

A. Yes. In my direct testimony I recommended a reduction in the Company's overall rate of return of 3.61 percent (8.33 percent less 4.725 percent) resulting in a reduction in requested revenues of approximately $16.3 million. The 8.33 percent, as referenced, is the Company's overall rate of return allowed on its Original Cost Rate Base as approved in Decision No. 73183 and the 4.725 percent represents the cost of debt directly related to the acquisition of Units 4 and 5.

Q. What was APS's position on RUCO's proposed adjustment?

A. APS disagreed with my proposed adjustment. Ms. Elizabeth Blankenship's rebuttal testimony best describes APS's disagreement with my recommendation.

"Decision No. 73130 did not say or imply that the cost of debt should be used in place of the WACC on the entire asset when the plant was placed in rate base. The debt-only capital treatment was strictly limited to the deferral balance. RUCO, however, extends the reach of that debt-return only treatment to all three of the items that make up the revenue requirement for this asset – not just the deferral balance. In leaving the rate case open to adjust rates to reflect the Four Corners transaction, the Settlement intended to allow the Four Corners asset the same rate of return as the other assets comprising the rate base in the Settlement's 2010 adjusted Test Year. Reducing the rate of return on that asset from the 8.33% WACC to a 4.725% documented debt cost would be inconsistent with the settlement."[1]

Mr. Jeffrey Guldner's testimony also states that "RUCO misapplied Decision No. 73130 by applying the marginal cost of debt used for cost deferral per that Decision as the applicable going forward rate of return. That is a clear misreading of Decision No. 73130 and is not consistent with the Settlement established precedent concerning FVROR."[2]

Q. Did APS at any time discuss calculating the return on the acquisition adjustment at the current cost of debt?

A. Yes. In Data Request 39.14 Staff ask the following: Please explain why it would not be appropriate to use APS's cost of debt (Marginal or Embedded) as the return on the acquisition adjustment in this case. APS responded that "this would be inconsistent with the Settlement and Decision No. 73183 and prior Commission precedent interpreting the requirements of the Arizona Constitution. Specifically, the Commission

[1] APS Witness Elizabeth Blankenship's Rebuttal Testimony Page 6
[2] APS Witness Jeffrey Guldner's Rebuttal Testimony Page 6

has determined that APS is entitled to the opportunity to earn a fair value rate of return based on the weighted average cost of two components of the Company's rate base: (1) APS's weighted average cost of capital (including equity return of 10%) as applied to OCLD (8.33% on an after tax basis); and (2) 1% as applied to the fair value increment (FVRB-OCRB). In this case, the requested fair value increment is zero, leaving the appropriate after tax return at 8.33%." Mr. Guldner went on to say in responding to the data request that if APS doesn't receive recovery of its request that it would very likely be poorly received in the financial community given the Commission's previous approval of this transaction.

Q. The Staff's data request related to the return on the acquisition adjustment, not the rate of return on rate base. Can you explain the relationship between the two?

A. In the current application the utility plant in service ("UPIS") increase is $225 million and of this amount $252 million represents acquisition adjustment. So in other words, the amount of the adjustment is entirely related to the acquisition adjustment. In this case the UPIS adjustment is the acquisition adjustment.

Q. Does RUCO have a response to the expected reaction of the financial community as discussed by Mr. Guldner?

A. No. I have no reason to question Mr. Guldner or his comments related to the financial community. However, when reviewing what Value Line has to say in its latest evaluation of Pinnacle West, included in its Investment Survey dated May 2, 2014, I note the following: **We have raised the Financial Strength rating of Pinnacle West from A to A+**. The fixed-charge coverage and common-equity ratio are high---well above average for the electric utility industry. Moreover, APS is very close to earning its allowed return on equity. **This high-quality stock is untimely but has a dividend yield that is slightly above the utility average.** However, with the recent price near the midpoint of our 2017-2019 Target Range, total return potential is unspectacular. (See Attachment A)

Q. How did APS fund the purchase price of Units 4 and 5 and other costs and expenses associated with this transaction?

A. "On January 10, 2014, APS issued $250 million of 4.70% unsecured senior notes that mature on January 14, 2044. The proceeds from the sale were used to repay commercial paper which was used to fund the purchase price and costs associated with the acquisition of SCE's 48% ownership interest in each of Units 4 and 5 of Four Corners and to replenish cash used to re-acquire two series of tax-exempt indebtedness."[3]

Q. So in essence the purchase of Units 4 and 5 was totally funded by debt and that no additional equity was necessary?

A. According to the Company's audited financial statements, this transaction was funded in total by short term debt and ultimately replaced by unsecured senior notes.

RUCO'S POSITION IN DOCKET NOS. 10-0274 AND 11-0224

Q. In the initial filing of Docket No. 10-0274, did RUCO agree that the closure of Units 1, 2 and 3 coupled with the purchase of Units 4 and 5 appeared to be a transaction that was in the public interest?

A. Yes. RUCO agreed that APS' analyses showed that the APS transaction saves APS' customers' money and has a lower bill impact than that of every likely alternative. RUCO also agreed that APS' proposed transaction significantly reduces carbon dioxide and other pollutant emissions; preserves the diversity of APS' current generation portfolio while tempering the Company's exposure to volatile natural gas prices, it maintains the mix of reliable base load energy; and it "saves hundreds of jobs and millions of dollars of revenue that are critical to the Navajo Nation and local economy.

[3] Pinnacle West Capital Corporation 2013 Annual Report Page 65

Q. In the settlement agreement testimony provided by RUCO in Docket No. 11-0224, did RUCO provide a summary of the benefits to the Company in settling this docket?

A. Yes. RUCO identified a number of benefits to the ratepayer in completing this transaction. However, RUCO's primary concern in that rate case was the continued improvement of APS's financial health that had been a concern in the prior rate case. As RUCO indicates in its testimony this settlement "provides them a rate rider for the Four Corners acquisition if that all should happen. And RUCO finds that extremely important for the Company's continued financial viability, because it will get plant in service into rate base in a more timely fashion. And according to the bill impact statement filed by APS on January 19th that showed the bill impact, we are looking at somewhere in 2013 an impact of around $2 to the average ratepayer for that Four Corners rate rider." [4]

Q. Since RUCO's testimony supported the rate case settlement agreement and the proposed inclusion of the plant in service in rate base, did RUCO's testimony include a specific rate of return on that new rate base item?

A. No. RUCO's testimony did not specifically identify an actual rate of return on the purchase of Units 4 and 5. Therefore the Commission has the ability to determine an appropriate rate of return on this transaction alone.

[4] RUCO's Settlement Testimony Page 1143, 1144

Q. What was the original purchase price for Units 4 and 5 and what was the purchase price once the transaction was completed?

A. The original purchase price was $294,000,000. The price was to be reduced by $7,500,000 for each month the project did not close with a final transaction date for completion of the project by December 31, 2013. After allowing for a fourteen month and twenty-nine day delay the final purchase price was reduced by $112,016,129.

Q. The transaction as filed in Docket No. 11-0224 estimated that the average rate increase would be approximately $2.00. Now, even though the purchase price was reduced by $112,016,129, the Company is requesting an increase of $2.92 for the average residential ratepayer?

A. Yes, basically the increase to the ratepayer is significantly higher in this filing versus the original request even though a much lower actual purchase price once the transaction was completed.

Q. Can you explain why APS request in now $2.97 compared to $2.00 calculation in their original estimates?

A. No. I can't.

Q. Does it appear then, that the original effect on ratepayers may not have been accurate in the Company's original calculations?

A. Yes. That appears to be correct.

Q. Was the $2.00 estimated effect on the residential ratepayer a major consideration in RUCO's evaluation of the total transaction?

A. Of course. RUCO's responsibility is to ensure that residential ratepayers are treated fairly while at the same time ensuring that utility companies are financial viable. In this case, considering the magnitude of the effect on ratepayers ($2.00 increase) coupled with the positive effects on the environment and the local economy RUCO recommended approval of the deal.

RUCO'S CURRENT POSITION

Q. Is RUCO continuing to recommend that the rate of return on this transaction be computed using the cost of debt specifically identified to this purchase transaction?

A. Yes. I am continuing to recommend that the cost of debt be used in calculating the rate of return on the purchase of Units 4 and 5.

Q. Can you reply to Mr. Guldner's rebuttal testimony that "RUCO misapplied Decision No. 73130 by applying the marginal cost of debt used for cost deferral per that Decision as the applicable going forward rate of return? That is a clear misreading of Decision No. 73130 and is not consistent with the Settlement established precedent concerning FVROR.

A. I'm going to answer that by including a comment from Mr. Leland R. Snook's rebuttal testimony. His testimony states that "RUCO interprets Decision No. 73130, (April 24, 2012) as somehow mandating the use of an incremental debt cost for this purpose. In reality, that Decision does not address how revenue requirements should be calculated for the Four Corners Transaction once that Transaction is reflected in rates." [5]

I'm going to agree with Mr. Snook's testimony. That decision does not identify how to calculate the revenue requirement. I would also add that in Decision No. 73183 (May 24, 2012) does not address how the revenue requirement is to be calculated. The Decision states that the acquisition of Units 4 and 5 is to be rate based, but does not define the rate of return to be applied to the purchase.

In addition, in reviewing Mr. Guldner's testimony in the rate case settlement proceedings on page 245, in replying to a question from

[5] Rebuttal testimony Mr. Snook, Docket No. 11-.224, this filing.

Commissioner Newman "what constructive rate treatment means," part of his response stated that "The settlement is very clear that says we're not judging what happens in that docket."[6]

Q. Does RUCO look at the two dockets as being independent and that one doesn't take precedence over the other?

A. RUCO looks at the two dockets as being independent with the exception that Decision No. 73183 was left open in order to include the Four Corners transaction at a future date. According to APS, each docket should be looked at as separate dockets.

Q. Does RUCO believe that its' primary concern for APS financial health has been improved since their settlement testimony in the last rate case Docket No. 11-0224?

A Yes. APS, per Value Line is a financially healthy utility and earning very close to its cost of equity, 9.7 percent in 2013. It is projected, by Value Line, to continue its earnings growth over the next two years; the financial strength as reported by Value Line was upgraded from A to A+; and a dividend yield that is slightly above average.

[6] Testimony of Mr. Guldner, Docket No. 11-0224, page 245

Q. Can you summarize RUCO's position on the filing?

A. RUCO is continuing to base its recommendation using the cost of debt as the rate of return in this filing. RUCO's position is based on the following: (1) Decision No. 73130 did not identify a specific rate of return and the cost of debt related to this transaction was used. The cost of debt was used by RUCO as the two dockets were to be decided independent of the other per the testimony of Mr. Guldner. (2) RUCO's final position in this case utilizing the cost of debt creates an estimated increase to the residential ratepayer in an amount that is very close to the APS's original increase of $2.00; (3) APS's financial stability has improved substantially since the last rate case settlement, and finally (4) the transaction was funded totally with debt with no additional equity required. For these reasons RUCO is continuing to recommend the reduction requested by APS by $16.23 million.

Q. Does this conclude your rebuttal testimony?

A. Yes.

ATTACHMENT A

PINNACLE WEST NYSE-PNW

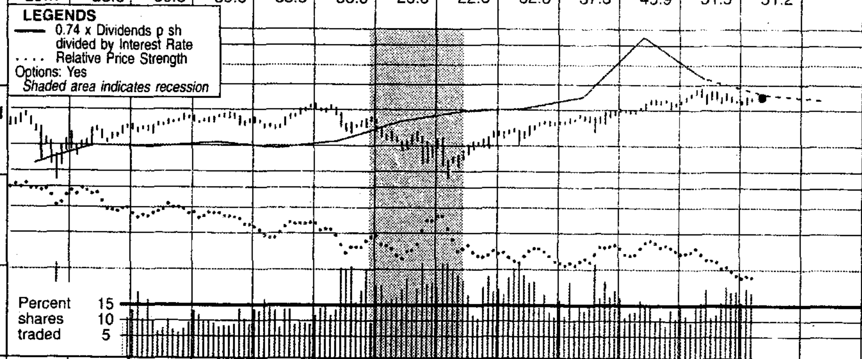
RECENT PRICE 55.60 | P/E RATIO 14.7 (Trailing: 15.2; Median: 15.0) | RELATIVE P/E RATIO 0.78 | DIV'D YLD 4.2% | VALUE LINE 2242

TIMELINESS 4 Lowered 4/4/14
SAFETY 1 Raised 5/3/13
TECHNICAL 2 Raised 3/21/14
BETA .75 (1.00 = Market)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
High:	40.5	45.8	46.7	51.0	51.7	42.9	38.0	42.7	48.9	54.7	61.9	56.7
Low:	28.3	36.3	39.8	38.3	36.8	26.3	22.3	32.3	37.3	45.9	51.5	51.2

Target Price Range
2017 | 2018 | 2019

LEGENDS
— 0.74 x Dividends p sh divided by Interest Rate
.... Relative Price Strength
Options: Yes
Shaded area indicates recession



2017-19 PROJECTIONS

	Price	Gain	Ann'l Total Return
High	65	(+15%)	8%
Low	50	(-10%)	2%

Insider Decisions

	J	J	A	S	O	N	D	J	F
to Buy	0	0	0	0	0	0	0	0	0
Options	0	0	0	0	0	0	0	0	0
to Sell	0	0	0	0	0	0	2	0	0

Institutional Decisions

	2Q2013	3Q2013	4Q2013
to Buy	189	172	169
to Sell	143	166	172
Hld's(000)	83505	83794	86068

Percent shares traded 15 10 5

% TOT. RETURN 3/14

	THIS STOCK	VL ARITH.* INDEX
1 yr.	-1.8	26.1
3 yr.	45.0	46.4
5 yr.	163.0	245.1

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	© VALUE LINE PUB. LLC	17-19
25.12	28.57	43.50	53.66	28.90	30.87	31.59	30.16	34.03	35.07	33.37	32.50	30.01	29.67	30.09	31.35	*32.65*	*33.75*	Revenues per sh	*36.00*
7.34	7.73	7.99	8.72	7.01	7.33	6.93	5.76	9.70	9.29	8.13	8.08	6.85	7.52	7.92	8.15	*8.40*	*8.80*	"Cash Flow" per sh	*9.50*
2.85	3.18	3.35	3.68	2.53	2.52	2.58	2.24	3.17	2.96	2.12	2.26	3.08	2.99	3.50	3.66	*3.70*	*3.85*	Earnings per sh A	*4.25*
1.23	1.33	1.43	1.53	1.63	1.73	1.83	1.93	2.03	2.10	2.10	2.10	2.10	2.10	2.67	2.23	*2.32*	*2.41*	Div'd Decl'd per sh B ■	*2.75*
3.76	4.05	7.76	12.27	9.81	7.60	5.86	6.39	7.59	9.37	9.46	7.64	7.03	8.26	8.24	9.36	*9.00*	*9.60*	Cap'l Spending per sh	*9.25*
25.50	26.00	28.09	29.46	29.44	31.00	32.14	34.57	34.48	35.15	34.16	32.69	33.86	34.98	36.20	38.07	*39.45*	*40.95*	Book Value per sh C	*45.00*
84.83	84.83	84.83	84.83	91.26	91.29	91.79	99.08	99.96	100.49	100.89	101.43	108.77	109.25	109.74	110.18	*110.25*	*110.30*	Common Shs Outst'g D	*118.00*
15.2	11.9	11.3	12.0	14.4	14.0	15.8	19.2	13.7	14.9	16.1	13.7	12.6	14.6	14.3	15.3	*Bold figures are*		Avg Ann'l P/E Ratio	*13.5*
.79	.68	.73	.61	.79	.80	.83	1.02	.74	.79	.97	.91	.80	.92	.91	.86	*Value Line*		Relative P/E Ratio	*.85*
2.8%	3.5%	3.8%	3.5%	4.5%	4.9%	4.5%	4.5%	4.7%	4.8%	6.2%	6.8%	5.4%	4.8%	5.3%	4.0%	*estimates*		Avg Ann'l Div'd Yield	*4.8%*

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015		17-19
2899.7	2988.0	3401.7	3523.6	3367.1	3297.1	3263.6	3241.4	3301.8	3454.6	*3600*	*3725*	Revenues ($mill)	*4250*
235.2	223.2	317.1	298.8	213.6	229.2	330.4	328.2	387.4	406.1	*410*	*430*	Net Profit ($mill)	*505*
35.4%	36.2%	33.0%	33.6%	23.4%	36.9%	31.9%	34.0%	36.2%	34.4%	*34.0%*	*34.0%*	Income Tax Rate	*34.0%*
6.9%	10.4%	11.1%	14.8%	17.5%	11.2%	11.7%	12.8%	9.7%	10.0%	*9.0%*	*8.0%*	AFUDC % to Net Profit	*6.0%*
46.7%	43.2%	48.4%	47.0%	46.8%	50.4%	45.3%	44.1%	44.6%	40.0%	*42.0%*	*44.0%*	Long-Term Debt Ratio	*39.0%*
53.3%	56.8%	51.6%	53.0%	53.2%	49.6%	54.7%	55.9%	55.4%	60.0%	*58.0%*	*56.0%*	Common Equity Ratio	*61.0%*
5535.2	6033.4	6678.7	6658.7	6477.6	6686.6	6729.1	6840.9	7171.9	6990.9	*7475*	*8055*	Total Capital ($mill)	*8675*
7535.5	7577.1	7881.9	8436.4	8916.7	9257.8	9578.8	9962.3	10396	10889	*11370*	*11890*	Net Plant ($mill)	*13600*
5.6%	5.0%	6.2%	5.9%	4.7%	4.8%	6.5%	6.4%	6.8%	7.1%	*6.5%*	*6.5%*	Return on Total Cap'l	*7.0%*
8.0%	6.5%	9.2%	8.5%	6.2%	6.9%	9.0%	8.6%	9.8%	9.7%	*9.5%*	*9.5%*	Return on Shr. Equity	*9.5%*
8.0%	6.5%	9.2%	8.5%	6.2%	6.9%	9.0%	8.6%	9.8%	9.7%	*9.5%*	*9.5%*	Return on Com Equity E	*9.5%*
2.3%	1.0%	3.4%	2.5%	.3%	.7%	3.1%	2.8%	4.1%	4.1%	*3.5%*	*3.5%*	Retained to Com Eq	*3.5%*
71%	85%	63%	70%	96%	89%	66%	68%	58%	58%	*62%*	*62%*	All Div'ds to Net Prof	*64%*

CAPITAL STRUCTURE as of 12/31/13
Total Debt $3490.0 mill. **Due in 5 Yrs** $1553.6 mill.
LT Debt $2796.5 mill. **LT Interest** $156.0 mill.
Incl. $13.4 mill. Palo Verde sale leaseback lessor notes.
(LT interest earned: 4.4x)
Leases, Uncapitalized Annual rentals $20.0 mill.
Pension Assets-12/13 $2264.1 mill. **Oblig.** $2646.5 mill.
Pfd Stock None

Common Stock 110,194,366 shs.
as of 2/14/14
MARKET CAP: $6.1 billion (Large Cap)

ELECTRIC OPERATING STATISTICS

	2011	2012	2013
% Change Retail Sales (KWH)	+1.8	-.2	-.2
Avg. Indust. Use (MWH)	632	647	644
Avg. Indust. Revs. per KWH (¢)	7.78	7.86	8.21
Capacity at Peak (Mw)	8577	8864	8398
Peak Load, Summer (Mw)	7087	7207	6927
Annual Load Factor (%)	50.0	48.8	50.0
% Change Customers (yr-end)	+.8	+1.3	+1.4
Fixed Charge Cov. (%)	308	397	419

ANNUAL RATES of change (per sh)	Past 10 Yrs.	Past 5 Yrs.	Est'd '11-'13 to '17-'19
Revenues	-2.0%	-2.5%	*3.0%*
"Cash Flow"	--	-3.0%	*3.0%*
Earnings	1.5%	4.0%	*4.0%*
Dividends	3.5%	2.5%	*3.0%*
Book Value	2.0%	1.0%	*3.5%*

Cal-endar	QUARTERLY REVENUES ($ mill.) Mar.31	Jun.30	Sep.30	Dec.31	Full Year
2011	648.9	799.8	1124.8	667.9	3241.4
2012	620.6	878.6	1109.5	693.1	3301.8
2013	686.6	915.8	1152.4	699.8	3454.6
2014	*700*	*950*	*1200*	*750*	*3600*
2015	*725*	*975*	*1250*	*775*	*3725*

Cal-endar	EARNINGS PER SHARE A Mar.31	Jun.30	Sep.30	Dec.31	Full Year
2011	d.15	.78	2.24	.11	2.99
2012	d.07	1.12	2.21	.24	3.50
2013	.22	1.18	2.04	.22	3.66
2014	*.15*	*1.20*	*2.20*	*.15*	*3.70*
2015	*.15*	*1.25*	*2.30*	*.15*	*3.85*

Cal-endar	QUARTERLY DIVIDENDS PAID B ■ Mar.31	Jun.30	Sep.30	Dec.31	Full Year
2010	.525	.525	.525	.525	2.10
2011	.525	.525	.525	.525	2.10
2012	.525	.525	.525	.545	2.12
2013	.545	.545	.545	.5675	2.20
2014	.5675				

BUSINESS: Pinnacle West Capital Corporation is a holding company for Arizona Public Service Company (APS), which supplies electricity to 1.1 million customers in most of Arizona, except about half of the Phoenix metro area, the Tucson metro area, and Mohave County in northwestern Arizona. Discontinued SunCor real estate subsidiary in '10. Electric revenue breakdown: residential, 49%; commercial, 39%; industrial, 5%; other, 7%. Generating sources: coal, 33%; nuclear, 27%; gas & other, 18%; purchased, 22%. Fuel costs: 32% of revenues. Has 6,400 employees. '13 reported deprec. rate: 3.0%. Chairman, President & CEO: Donald E. Brandt. Inc.: AZ. Address: 400 North Fifth St., P.O. Box 53999, Phoenix, AZ 85072-3999. Tel.: 602-250-1000. Internet: www.pinnaclewest.com.

Pinnacle West's utility subsidiary has a single-issue rate case pending. In late 2013, Arizona Public Service paid $182 million for another utility's 739-megawatt stake in Units 4 and 5 of the Four Corners coal-fired station. It retired Units 1, 2, and 3. The utility is seeking a $62.5 million (2.2%) tariff increase in order to place the newly purchased assets in the rate base. A ruling from the Arizona Corporation Commission (ACC) could occur by yearend. APS will also have to spend an estimated $350 million for environmental upgrades, most of which will be incurred in 2016 and 2017.

The utility wants to add some generating capacity. APS is proposing to retire 220 mw of old capacity at a gas-fired plant and build 510 mw at the site, for a net increase of 290 mw. Along with 110 mw that will remain, this would bring the plant's capacity to 620 mw. The project requires a certificate of need from the ACC, which should come in late 2014 or early 2015. The estimated cost is $600 million-$700 million, and the new units are targeted for completion in the second quarter of 2018.

We expect just slight earnings growth in 2014. Each year, APS receives some rate relief for certain expenditures such as transmission. The service area's economy has recovered from the effects of the housing crisis, and this is reflected in improving customer growth rates. Kilowatt-hour sales should advance modestly, despite the effects of conservation (including installation of solar panels). However, expenses will likely wind up higher, too. Our estimate is within the company's targeted range of $3.60-$3.75 a share. We forecast 4% profit growth next year, assuming the utility gets rate relief for Four Corners.

We have raised the Financial Strength rating of Pinnacle West from A to A+. The fixed-charge coverage and common-equity ratio are high—well above average for the electric utility industry. Moreover, APS is very close to earning its allowed return on equity.

This high-quality stock is untimely, but has a dividend yield that is slightly above the utility average. However, with the recent price near the midpoint of our 2017-2019 Target Price Range, total return potential is unspectacular.

Paul E. Debbas, CFA *May 2, 2014*

(A) Diluted EPS. Excl. nonrec. losses: '02, 77¢; '09, $1.45; excl. gains (losses) from disc. ops.: '00, 22¢; '05, (36¢); '06, 10¢; '08, 28¢; '09, (13¢); '10, 18¢; '11, 10¢; '12, (5¢). '11 EPS don't add due to rounding. Next earnings report due early Aug. (B) Div'ds historically paid in early Mar., June, Sept., and Dec. There were 5 declarations in '12. ■ Div'd reinvestment plan avail. (C) Incl. deferred chgs. In '13: $7.71/sh. (D) In mill. (E) Rate base: Fair value. Rate allowed on com. eq. in '12: 10%; earned on avg. com. eq., '13: 9.9%. Regulatory Climate: Avg.

Company's Financial Strength	A+
Stock's Price Stability	100
Price Growth Persistence	60
Earnings Predictability	65

ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-11-0224

SURREBUTTAL TESTIMONY

OF

LON HUBER

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

JULY 21, 2014

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INTRODUCTION

Q. Please state your name, position, employer and address.

A. Lon Huber. I am a special projects advisor for Arizona's Residential Utility Consumer Office ("RUCO"), located at 1110 W. Washington, Suite 220, Phoenix, AZ 85007.

Q. Please state your educational background and work experience.

A. I started working in the energy field in 2007 at a research institute housed within the University of Arizona. In 2010, I became the governmental affairs staffer for TFS Solar, an integrator based in Tucson. I was hired by Suntech America in 2011 as a Manager of Regional Policy where I served as the point person for the company in numerous US states. Next, I started working in economic development as a senior analyst for the Greater Phoenix Economic Council while also serving as a consultant for RUCO on energy issues. I joined RUCO as a full time employee in January 2014.

I obtained a Bachelor of Science Public Administration degree in Public Policy and Management from the University of Arizona in 2009. I also received a Masters of Business Administration from the Eller College of Management at the same university. My primary residence is in Tucson, Arizona.

Q. Please state the purpose of your testimony.

A. The purpose of my testimony is to address the Four Corners Adjustment rider's applicability to customers served under the AG-1 Rate Schedule. In doing so, I respond to the testimonies of Mr. Higgens and Mr. Chriss.

Q. Please summarize your conclusion and recommendation.

A. My determination is that APS was overly generous to AG-1 customers regarding the manner at which they applied the proposed 2.22 percent Four Corners Adjustment rider. Therefore, I am proposing a more equitable allocation of costs that does not unfairly burden non AG-1 ratepayers.

OVERVIEW OF ISSUE

Q. Please provide a high-level overview of the issue at hand.

A. AG-1 is an experiential rate rider that provides a buy through mechanism for large commercial and industrial customers. The rider is capped at 200 MW and falls on top of the customer's underlying rate schedule, mostly supplanting the costs of electrical generation. The details of the rate rider were worked out during the settlement process and adopted as part of the settlement agreement in Decision No. 73183 "Settlement." In parallel, another provision in the settlement related to the potential acquisition of certain units at the Four Corners power plant and the allocation of those costs should the transaction be executed. The Four Corners Adjustment rider "FCA" is the proposed mechanism to allocate these costs in accordance to provision 10.3 in the

Settlement. Mr. Higgins and Mr. Chriss are seeking exemption for their clients on any and all costs associated with the Four Corners investment.

Q. Please provide comment on section 10.3 of the Settlement as it relates to your testimony.

A. Section 10.3 very clearly explains that the cost recovery rider will apply to all rate schedules. Specifically, part five of section 10.3 states the following: "(5) an adjustment rider that recovers the rate base and non-PSA related expenses associated with any Four Corners acquisition on an equal percentage basis across all rate schedules which shall not become effective before July 1, 2013. "

Q. Did you personally participate in the 2012 settlement process?

A. No I did not.

Q. Please comment on APS's proposed approach to the FCA.

A. Overall, APS properly applied the FCA to the various rate schedules in accordance with section 10.3 of the Settlement. In general, APS assessed the proposed 2.22 percent rider to all portions of the bill representing services provided by APS. This includes the non-generation related services of each rate schedule.

Q. Did the Company fully apply the Four Corners Adjustment rider to the services provided to AG-1 customers?

A. Not entirely.

Q. Please Explain.

A. APS is proposing to apply the Four Corner Rate Rider to only a subset of the AG-1 customer bill. From dialogue at the February 19^{th} technical conference, roughly 70 percent of an AG-1 customer bill is shielded from the Four Corners investment. However, upon investigation into the FCA's applicability to AG-1 customers I noticed that APS did explicitly state that the Company would apply the FCA to the reserve capacity charge. Therefore, I recommend that the order make it clear that the FCA applies to the reserve capacity charge.

Q. Please describe the reserve capacity charge.

A. It is a generation related component within the AG-1 rate rider. The reserve capacity charge is about a $6.985 per kW month charge that is applied to 15 percent of the customer's billed kW.

Q. With the exception of the reserve capacity charge was APS's proposed treatment of AG-1 customers fair?

A. Yes, I believe APS was extremely fair and balanced and could have easily decided to assess the charge on the entire bill of an AG-1 customer.

Q. How do you address Mr. Higgens' and Mr. Chriss' claims that their clients should be completely exempted?

A. They appear to have a misunderstanding of the FCA. APS is applying the FCA on every element of base rates. AG-1 customers still have an underlying rate plan. It is important to note that the FCA is not applied to only the generation portion of a customer's bill. Further, the Settlement makes no connection between what type of asset the FCA is actually collecting costs for and the portion of the customer's bill it applies to. However, Mr. Higgens and Mr. Chriss are using a provision in the AG-1 rider schedule and inappropriately enlarging that clause to shield them from any and all costs associated from the Four Corners acquisition.

Q. Can you provide an example of this misunderstanding?

A. Mr. Higgens states the following: "...AG-1 customers would be forced to pay for generation costs even though these customers are purchasing the entirety of their AG-1 generation supply from non-APS source."[1] The fundamental misunderstanding is that the rider is not representing generation costs associated with the actual electricity production of the Four Corners power plant. The FCA largely represents the actual investment costs of the acquired units. The costs of this acquisition are to be spread equally across all rate plans. Another way to think about it is to entertain for a moment that the FCA

[1] Page seven of Mr. Higgens' direct testimony.

is recovering costs of constructing an administrative building. Would it not be fair to allocate the costs of this asset in the manner APS proposes?

If you follow through with the argument employed against applying the FCA to underlying rate design of AG-1 customers, one would have to argue that some of the employees in that building will be working on generation related projects; therefore, the costs can not apply to AG-1 customers.

Q. Please explain how Mr. Higgens and Mr. Chriss are misapplying a clause in the AG-1 rider schedule?

A. Mr. Higgens and Mr. Chriss point to a line on page four of attachment J in the 2012 settlement. Under the heading "Rates," it states: "All provisions, charges and adjustments in the customer's applicable retail rate schedule will continue to apply except as follows:..." One of those exceptions states "The generation charges will not apply."

What this clause is referring to is the generation portion of the customer's underlying rate design. Clearly, the actual generation costs of providing energy and power to the customer as specified in their underlining rate design is exempted from the AG-1 rate because the customer is procuring power elsewhere. The clause does not read that AG-1 customers will be exempted from the acquisition costs of generation related assets. Furthermore, APS is only applying those costs to services relating to the customer's underlying rate schedule not the larger pass through portion of bill.

RECOMMENDATION

Q. What does RUCO recommend on this issue?

A. I recommend that the FCA apply to AG-1 customers just as APS proposed but with the inclusion of the reserve capacity charge.

Q. Is it fair to AG-1 customers?

A. Yes. Again, this proposal is fair and could have been assessed on the entire bill. Contrary to Mr. Chriss' claims that the proposed FCA violates cost causation and matching principles, the suggested FCA aligns nicely with those principles in the context of the 2012 Settlement.

Q. Please explain.

A. AG-1 is meant to be a four year experimental rate. By claiming there is no benefit from the Four Corners investment to AG-1 customers assumes that this rate will go on in perpetuity. It also ignores the generation related component that APS charges within the AG-1 rider. Because this is a short term rate rider offering, APS must still plan their system with long term reliability and cost considerations in mind. This includes the reintroduction of AG-1 customers. In fact, it could be argued that the FCA should be applied to more than just 30 percent of an AG-1 customer's bill. According to Jeffrey

Guldner, AG-1 customers burden all other customers with around $20 million in fixed cost shifts.[2] Following the cost causation principle, as Mr. Chriss suggests, would dictate that this cost shift must be rectified as soon as possible.

Q. Does this conclude your testimony?

A. Yes it does.

[2] RUCO Electric Deregulation Workshop, August 27, 2013.