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COMMISSIONERS

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

I. INTRODUCTION.

Arizona Corporation Commission Staff ("Staff") hereby submits its Initial Post-Hearing Brief regarding Arizona Public Service Company's ("APS" or "the Company") Application requesting Commission approval of a Four Corners Rate Rider. APS's Application is a result of Decision No. 73183 which approved a Settlement Agreement in APS's last rate case. Pursuant to Decision No. 73183, the Commission has held the rate case open so that the Company may seek rate treatment associated with its acquisition of Southern California Edison's ("SCE") share of Four Corners Units 4 and 5. The Company may also seek recovery of the costs associated with the retirement of Units 1, 2 and 3 and of the deferred costs resulting from the accounting order approved in Decision No. 73130. Staff recommends that the Commission find the transaction to be prudent, that the Commission allow recovery of the $254 million acquisition adjustment resulting from the purchase, and that the Commission retain the 6.09 percent fair value rate of return ("FVROR") thereby reducing APS's proposed revenue increase by $8.39 million.

II. BACKGROUND.

A. The Four Corners Power Plant.

The Four Corners Generating Station is a coal-fired power plant located near Fruitland, New Mexico. It is situated on property within Navajo Tribal Lands that is leased from the Navajo Nation.

Four Corners originally consisted of five units with a total rated generating capacity of about 2,040 MW. APS owns 100 percent of Units 1, 2 and 3, older units that were completed in 1963 and 1964.[1] Those units generated a combined 560 MW.[2] Units 4 and 5 are newer units which were completed in the 1969 to 1970 timeframe.[3] Units 4 and 5 are co-owned by five companies, with APS owning 63 percent (after its acquisition of SCE's 48 percent share), Public Service Company of New Mexico owning 13 percent, Salt River Project owning 10 percent, Tucson Electric Power owning 7 percent, and El Paso Electric owning 7 percent.[4] APS operates Units 4 and 5 on behalf of all of the other co-owners. Shortly after acquiring SCE's 48 percent share of Units 4 and 5, APS shut down Units 1, 2 and 3. With the shutdown of Units 1 through 3, the capacity of Four Corners is currently at 1,540 MW. The plant serves customers in Arizona, Texas and New Mexico.[5]

B. <u>The Transaction.</u>

Under the Purchase and Sale Agreement ("Sale Agreement"), APS was to pay a cash price of $294 million and assume certain SCE obligations, including decommissioning costs, mine reclamation liabilities, and other costs.[6] The transaction was originally scheduled to close on October 1, 2012.[7] The Sale Agreement also provided that the cash price would increase by $7.5 million per month for each month the closing date was accelerated, and decrease by $7.5 million per month for each month the closing was delayed.[8]

As part of an agreement with the Environmental Protection Agency ("EPA") to improve noxious emission levels at the plant, APS shut down Units 1, 2 and 3 immediately after its purchase of Units 4 and 5 from SCE.[9] Overall, the transaction will result in reduced emission levels of

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[1] Dec. No. 73130 at 2.
[2] *Id.*
[3] *Id.*
[4] *Id.* El Paso will fully divest its interest by 2016. Tr. at 122-23.
[5] Tr. at 123.
[6] *See,* Purchase and Sale Agreement between APS and SCE, Ex. S-4.
[7] *See, Id.*
[8] *See, Id.*
[9] On October 19, 2010, the EPA published a proposed Federal Implementation Plan requiring Four Corners to achieve emissions reductions required by the Clear Air Act's Best Available Retrofit Technology ("BART") provision. On November 24, 2010, APS, on behalf of all Four Corners' owners, submitted a letter to EPA offering an alternative proposal where APS would shut down Units 1-3 by 2014 and install and operate Selective Catalytic Reduction ("SCR") technology on Units 4 and 5 by the end of 2018.

millions of tons of carbon dioxide. Before the transaction, APS had 560 MW from Units 1, 2, and 3 and 231 MW from Units 4 and 5. After the transaction, APS has 231 MW representing its pre-purchase 15 percent ownership interest of Units 4 and 5, and an additional 740 MW representing SCE's 48 percent share, which it purchased.[10] Thus, APS added 179 MW as a result of the transaction.[11]

C. APS Power Procurement.

APS's acquisition of generation is governed by Decision No. 67744 and the Commission's procurement rules. In APS's 2003 rate case, the Commission, in Decision No. 67744, adopted a Settlement Agreement which provided that "APS will not pursue any self-build option having an in-service date prior to January 1, 2015, unless expressly authorized by the Commission."[12] To obtain Commission authorization to self-build generation prior to 2015, APS has to address the following factors:

a. The Company's specific unmet needs for additional long-term resources.

b. The Company's efforts to secure adequate and reasonably-priced long-term resources from the competitive wholesale market to meet those needs.

c. The reasons why APS believes those efforts have been unsuccessful, either in whole or in part.

d. The extent to which the request to self-build generation is consistent with any applicable Company resource plans and competitive resource acquisition rules or orders resulting from the workshop/rulemaking proceeding described in paragraph 79.[13]

e. The anticipated life-cycle cost of the proposed self-build option in comparison with suitable alternatives available from the competitive market for a comparable period of time.

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[10] Letzelter Dir. Test., Ex. S-1, attached Liberty Report at 4.

[11] *Id.*

[12] Decision No. 67744 also modified the definition of "self-build," requiring APS to obtain Commission authorization before it "acquires any unit or interest in a generating unit other than 'the acquisition of temporary generation needed for system reliability, distributed generation of less than fifty MW per location, renewable resources, or the up-rating of APS generation'" when the in-service date is prior to January 1, 2015.

[13] Paragraph 79 of Decision No. 67744 stated that: "The Commission Staff will schedule workshops on resource planning issues to focus on developing needed infrastructure and developing a flexible, timely, and fair competitive procurement process. These workshops will also consider whether and to what extent the competitive procurement should include an appropriate consideration of a diverse portfolio of short, medium, and long-term purchased power, utility-owned generation, renewables, Demand Side Management, and distributed generation. The workshops will be open to all stakeholders and to the public. If necessary, the workshops may be followed with rulemaking."

In Decision No. 71722, the Commission adopted new rules pertaining to procurement and independent monitors. Those rules are contained at Arizona Administrative Code ("A.A.C.") R14-2-705 et seq.

D. Decision No. 73130.

On November 22, 2010, APS filed an application with the Commission for authority to purchase SCE's interest in Units 4 and 5 under the provisions of the "self-build moratorium contained in Decision No. 67744; and for an accounting order authorizing certain cost deferrals associated with the acquisition.[14] In that proceeding, both Staff and the Residential Utility Consumers' Office ("RUCO") supported waiver of the self-build moratorium. Staff noted that the transaction would provide "unique value to APS's customers by having a net present value that is $488 million less than the natural gas generation alternative, and $1.08 billion less than the alternative of upgrading Units 1-3; by using a fuel that is less volatile and that limits over reliance on a single generation resource."[15] RUCO believed that the proposed transaction was in the best interest of ratepayers providing both economic and environmental benefits. Western Resource Advocates ("WRA") and Environmental Defense Fund ("EDF") also supported a waiver of the requirements of Decision No. 67744 because in their view the proposed transaction represented a "genuine, unanticipated opportunity for APS to acquire a power supply at a clear and significant discount that provided unique value to APS's customers."[16] The Sierra Club opposed APS's request to acquire Units 4 and 5 in part because of uncertainties associated with upcoming EPA environmental requirements.

In Decision No. 73130, the Commission found that APS had adequately addressed Decision No. 67744's requirements for waiver of the self-build moratorium. The Commission also found that

[14] The Company's acquisition of SCE's interest in Four Corners Units 4 and 5 represents the culmination of several separate matters. As explained in Decision No. 73130 (April 24, 2012), California adopted legislation that effectively required the establishment of a greenhouse gas emission standard. Based on that California legislation, the California Public Utilities Commission ("CPUC") created an emissions performance standard that prohibited SCE from entering into a long-term commitment involving base load generation unless it complied with the new emission standard. Although SCE sought an exemption for Four Corners from the requirements of the emission standard, the CPUC denied SCE's request for exemption and denied SCE rate recovery of any capital expenditures planned for Four Corners Units 4 and 5 after January 1, 2012 if the expenditures would extend the life of the plant by five years or more. Decision No. 73130 at 4, citing CPUC Decision No. 10-10-016 at 30.

[15] Dec. No. 73130 at 23.

[16] *Id.* at 24.

the proposed purchase represents a "genuine unanticipated opportunity" under R14-2-705(B)(5) of the procurement rules. The Commission further found that the proposed purchase was consistent with the Company's resource plans and the competitive procurement rules.

In Decision No. 73130, the Commission also granted APS's request for an accounting order and authorized various accounting deferrals for potential consideration in a future rate case. In note 122 of Decision No. 73130, the Commission stated that "[t]he 'non-fuel costs' that are authorized for deferral include: depreciation, amortization of the acquisition adjustment, decommissioning costs, operations and maintenance costs, property taxes, final coal reclamation costs, the documented debt costs of acquiring SCE's interest in Units 4 and 5, and miscellaneous other costs."[17] Decision No. 73130 expressly did not address the prudency of the acquisition, leaving that determination to APS's next rate case.

E. Decision No. 73183.

On June 1, 2011, the Company filed a rate application with the Commission to determine the fair value of its utility property for ratemaking purposes, to fix a just and reasonable rate of return thereon, and to approve rate schedules designed to develop such return. On May 24, 2012, the Commission issued Decision No. 73183, which approved a Settlement Agreement between certain parties in that case, including APS, Staff and RUCO. Section X of the Agreement provided for possible rate treatment related to any acquisition by APS of SCE's ownership interest in Four Corners Units 4 and 5. Section 10.2 specifically provided that the rate case would be held open for the "sole purpose of allowing APS to file a request, no later than December 31, 2013, that its rates be adjusted to reflect the proposed Four Corners transaction should the Commission allow APS to pursue the acquisition and should the transaction thereafter close." Section 10.2 also provided that "APS's rates shall be adjusted only if the Commission finds the Four Corners transaction to be prudent."

In Decision No. 73183, the Commission also approved provisions in the Settlement Agreement providing for AG-1, an alternative generation rate for industrial and large commercial

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[17] *Id.* at 37.

customers. As noted by the Commission, the experimental schedule is designed to give larger commercial customers of APS greater control over their energy costs.[18]

APS filed an Application for Approval of the Four Corners Rate Rider on December 30, 2013. In this case, the Commission must determine whether the transaction was prudent, and whether the revenue increase proposed by APS results in a surcharge that is fair, just and reasonable. In addition, the Commission will need to address the applicability of the Four Corners surcharge to AG-1 customers.

III. APS'S PURCHASE OF SCE'S INTEREST IN FOUR CORNERS UNITS 4 AND 5 IS IN THE PUBLIC INTEREST AND WAS PRUDENT.

A. The Transaction Is in the Public Interest and Was Prudent.

Staff undertook an evaluation of the prudency of the transaction as part of its evaluation of APS's request for rate recovery of the rate base and expense effects related to the acquisition of SCE's interest in Four Corners Units 4 and 5. On behalf of Staff, James Letzelter undertook a robust analysis of the transaction that tested the validity of APS's analytical approach and the data and models used by APS to support the prudency of the acquisition. As part of his prudency evaluation, Mr. Letzelter evaluated the Company's need for capacity, scrutinized the timing of the acquisition, examined the risks related to the transaction, and considered ancillary benefits of the transaction. Based on Mr. Letzelter's analysis, Staff believes that the transaction was prudent and that rate recovery pursuant to the terms of the Settlement Agreement adopted by Decision No. 73183 is appropriate. The only party contesting prudency in this case is the Sierra Club.

B. The Capacity Provided by Four Corners Is Necessary.

Purchase of SCE's 48 percent interest will allow APS to acquire SCE's 740 MW of generation capacity from Units 4 and 5. As part of the transaction, APS retired Units 1-3, older units which only generated a combined 560 MW. These units would also have required significant environmental upgrades. The acquisition of SCE's share of Four Corners Units 4 and 5 results in a net increase of 179 MW to APS's generation supply.[19] The additional generation will elevate APS's

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[18] Dec. No. 73183 at 24.
[19] Letzelter Dir, Test., Ex. S-1, attached Liberty Report at 4.

reserve capacity to 33.6% percent in the near term, more than double the North American Electric Reliability Corporation's ("NERC") default reserve margin requirement of 15 percent.[20]

Staff's analysis indicates that the additional capacity is useful in light of APS's continued load growth and the scheduled reduction in other supply resources. A review of the Company's Integrated Resource Plan ("IRP") filings for 2014 reveals that APS's projected rate of load growth will increase its generation needs annually by approximately 265 MW.[21] The retirement of Units 1-3 would, in the absence of acquiring SCE's share of Units 4 and 5, cause APS to be in a serious capacity shortfall in the near term, as of 2016. With SCE's share of Units 4 and 5, APS has capacity in excess of its needs for the period 2014-2016; but according to Mr. Letzelter this diminishes at a reasonable rate due to the factors discussed above.[22] Mr. Letzelter found that for the 2017 to 2023 timeframe, "the supply plan produces near optimum annual reserve margins."[23]

Staff tested various scenarios to evaluate the impact on APS's reserve margins. Those scenarios included (1) the Company going through with its plan to acquire SCE's interest in Units 4 and 5 and retiring Units 1-3, (2) the Company not acquiring SCE's shares of Units 4 and 5 and keeping Units 1-3 in operation, and (3) the Company not acquiring the additional capacity from Units 4 and 5 and retiring Units 1-3. In terms of maintaining a reliable reserve margin, the acquisition of SCE's interest in Four Corners Units 4 and 5, in conjunction with the retirement of Units 1-3, presented the most reasonable, economic and beneficial outcome.[24]

C. **<u>The Transaction Is Economically Sound.</u>**

Staff also evaluated the economic aspects of the transaction by comparing the net present value ("NPV") impact of various alternative scenarios to the NPV impact of APS's plan to acquire SCE's interest in Units 4 and 5 and to retire Units 1, 2 and 3. APS's models projected a $425.6 million NPV for the transaction, compared to the next best alternative, which was the acquisition of new gas fired generation. While Staff's analysis found that the overall economics of the transaction are lower than APS had projected, Staff noted the NPV of the transaction is still sufficiently high to

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[20] *Id.*
[21] *Id.* at 4-5.
[22] *Id.* at 5.
[23] *Id.*
[24] *Id.* at 5-6.

demonstrate a significant benefit. Staff's analysis produced a NPV of $315.5 million. The difference in NPV between Staff's and APS's analyses was largely due to two factors: future gas prices and CO_2 emissions costs. With respect to both gas prices and CO_2 costs, there is great uncertainty.[25]

The Sierra Club claims that APS's inputs for future gas prices are inappropriately high.[26] Staff's analysis reached the opposite conclusion and found that APS's fuel price modeling produced a conservatively low estimate of natural gas prices. Staff independently examined the gas price projections of the Energy Information Administration's ("EIA") 2014 Energy Outlook Report for multiple fuel source locations and added the costs of transporting gas to reach APS's gas generation.[27] Staff's analysis showed that APS had used a conservatively lower value for gas prices (making gas generation appear more economic) in its forecasts. Staff's review indicated that, based on gas price forecasts, the transaction is more economic than projected by APS. Thus, Staff's analysis incorporated higher gas prices than projected by APS, leading to a higher value for acquisition benefits.[28]

However, with regard to the cost of CO_2 emissions, Staff found that APS's analysis had underestimated both the impacts and the costs of CO_2 regulation. Staff's analysis incorporated higher CO_2 costs than projected by APS leading to lower acquisition benefits.[29]

While this case was pending, the EPA issued proposed rules under the Clean Air Act to reduce carbon dioxide emissions. The rules require a 30 percent reduction in carbon emissions by 2030.[30] The rules have generated a lot of concern with respect to the future viability of coal plants in the United States. While EPA's proposed rules do not apply to power plants on tribal lands at this time, it is expected that the EPA will release a similar proposal for these plants sometime this year.[31] Staff witness Letzelter opined that while the proposed regulation will drive some plants into early retirement, in his opinion Four Corners would not be one of them.[32] Mr. Letzelter also stated that

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[25] *Id.* at 12.
[26] See e.g. Hausmann Dir. Test., Ex. SC-1 at 17-24; Hausmann Surreb. Test., Ex. SC-2 at 2-4; Tr. at 243-46.
[27] Letzelter Dir. Test., Ex. S-1, attached Liberty Report at 8.
[28] *Id.* at 10-13.
[29] *Id.*
[30] *Id.* at 9; Tr. at 589-90.
[31] Tr. at 589-90.
[32] *Id.* at 590.

while "there remains a need to address goals and requirements for some facility locations [it] does not change our view or suggest the use of different assumptions about the exposure faced by Four Corners."[33]

While Staff's model produced possible negative NPVs as low as (-) $147 million, it also generated possible positive NPVs as high as $748 million.[34] Nonetheless, Staff found, with a ninety percent confidence interval, that the NPV will be between $97 million to $512 million.[35] Moreover, Staff found that there is a 99.4 percent chance that the transaction will have a positive NPV.[36]

In light of the high likelihood that the transaction will yield a positive NPV for the Company, Staff believes that the transaction is economic.

D. <u>The Timing of the Transaction Was Appropriate.</u>

The Sale Agreement provided for a monthly closing price reduction of $7.5 million for every month after October 2012.[37] The purchase price "represented an ambivalence point for SCE, at which replacement power could be purchased in lieu of the production from Four Corners."[38] The actual closing date was December 30, 2013, bringing the final cash price for the acquisition of SCE's interest in Units 4 and 5 to approximately $181 million.[39]

Staff's analysis of the timing of the acquisition recognized that several important choices presented themselves, and APS had a narrow window of time within which to act. The Company faced high capital expenditures to bring Units 1-3 into compliance with environmental regulations. In order to keep Units 1-3 in operation over the long-term, APS would have to spend approximately $1 billion to install Selective Catalytic Reduction for NO_x control. Without these upgrades, APS would have had to shut down the units by 2014.[40] If these units were retired, APS would have had to replace the 560 MW of generation that they formerly produced.

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[33] Letzelter Dir. Test., Ex. S-1, attached Liberty Report at 9.
[34] *Id.* at 13.
[35] *Id.*; Tr. at 587.
[36] Tr. at 588.
[37] *See,* Purchase and Sale Agreement between APS and SCE, Ex. S-4.
[38] Letzelter Dir. Test., Ex. S-1, attached Liberty Report at 13.
[39] *Id.*
[40] *Id.* at 3, 13.

APS also faced the possibility that SCE would decline to make the necessary capital expenditures to maintain Units 4 and 5, due to California's new greenhouse gas emission standards and requirements. Prior to the transaction, APS had a fifteen percent interest in Units 4 and 5.[41] However, SCE's inability to make any life-extending capital expenditures would likely have necessitated the retirement of the units in 2016.[42] As the units were no longer viable to SCE, it would likely have "harvested" them, despite the fact that the other utilities had viable and varying degrees of ownership interests in them.[43]

Staff believes that APS timed the transaction in a manner which appropriately balanced shareholder and customer interests.[44]

E. The Risks of the Transaction Are Offset by Favorable Economics.

While the risks of the transaction defy perfect quantification and mitigation, Staff's review of the transaction concluded that the reasonably foreseeable risks are more than offset by the economic benefits of the transaction. The acquisition allows APS to acquire additional generation that is consistent with APS's projected load growth. At the same time, it allows APS to maintain a diverse resource portfolio that is not overly exposed to fuel price volatility. Despite increases in America's supply of natural gas, recently experienced weather conditions affecting gas deliveries coupled with the lack of gas storage in our state suggest that over-reliance on any fuel source is inadvisable.[45]

F. Additional Benefits Presented by the Transaction.

Staff further noted that the transaction also provides benefits in the nature of retaining jobs in the area, both for the power plant, for the Navajo Nation, and for the coal mine that provides fuel to the plant.[46] Likewise, the transaction will allow APS to protect its existing fifteen percent interest in Units 4 and 5. In conjunction with the $315.5 million in NPV benefit presented by the transaction, and the addition of 179 MW of additional capacity, Staff views the transaction as a prudent acquisition that is economically beneficial to the Company and to its ratepayers.

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[41] Tr. at 134.
[42] Letzelter Dir. Test., Ex. S-1, attached Liberty Report at 14.
[43] Tr. at 135.
[44] Letzelter Dir. Test., Ex. S-1, attached Liberty Report at 14.
[45] *Id.* at 15.
[46] *Id.* at 16.

IV. THE COMMISSION SHOULD REJECT APS'S PROPOSED REVENUE INCREASE BECAUSE IT IS NOT BASED UPON THE FAIR VALUE RATE OF RETURN AGREED TO IN THE SETTLEMENT ADOPTED BY THE COMMISSION IN DECISION NO. 73183.

The rate base impact of the Four Corners acquisition is approximately $217,629,000 (through June 30, 2014).[47] The Company then applied an 8.33 percent rate of return and the revenue conversion factor approved by the Commission in the last rate case to calculate its proposed revenue deficiency of $62,529,000 (through June 30, 2014).[48] APS's use of an 8.33 percent rate of return, however, is not consistent with the Settlement Agreement approved by the Commission in Decision No. 73183.

A. <u>Of the Three Rate of Return Proposals in this Case, Staff's Proposed Rate of Return Is the Only One which Is Supported by the Settlement Agreement Approved by the Commission.</u>

There are three different rate of return proposals in this case. APS proposes to use an 8.33 percent return on fair value rate base. This results in a revenue increase of $65.44 million (updated to November 30, 2014).[49] Staff uses the 6.09 percent return agreed upon in the Settlement Agreement adopted by the Commission.[50] Staff's position would result in a revenue increase of $57.05 million, which would reduce APS's updated revenue requirement by $8.39 million.[51] RUCO, on the other hand, advocates the use of the incremental cost of debt of 4.725 percent as the appropriate rate of return. RUCO's proposal would result in a revenue requirement of $49.20 million, which is a reduction of $16.24 million to APS's proposed revenue requirement.[52]

Staff's proposal is the only proposal that is supported by the Settlement Agreement adopted by the Commission in Decision No. 73183. The 6.09 percent used by Staff is the fair value rate of return agreed to by the parties in Section V of the Settlement Agreement.

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[47] Kalbarczyk Dir. Test., Ex. S-2 at 13.
[48] *Id.* at 12.
[49] Blankenship Reb. Test, Ex. APS-11 at 4.
[50] Kalbarczyk Dir. Test., Ex. S-2 at 9.
[51] Kalbarczyk Dir. Test., Ex. S-3 at 9.
[52] *Id.* at 3.

1. The Relevant Provisions of the Settlement Agreement Are Not Ambiguous.

Section 10.2 of the Settlement Agreement, which provides for rate treatment of APS's acquisition of SCE's share of Four Corners, states only that the "rate base and expense effects" associated with the acquisition shall be recognized. There is no similar reference, or for that matter any reference, to the "fair value rate of return." In the public utility context, it is well recognized that the required revenues of a firm are equal to its rate base times its rate of return plus expenses. Section 10.2 specifies that the rate treatment is to include the rate base and expenses, or two parts of this equation. There is nothing said about a change to the third part of the equation, the rate of return.

Had the parties intended to update the FVROR, language could have easily been inserted into Section 10.2 of the Agreement to allow for recalculation of the rate of return as well as rate base and expenses. But it was not. Given the clear language of Sections V and X of the Agreement, recalculating the FVROR would be inappropriate.

A settlement agreement is a contract subject to rules of statutory construction. *Carey v. Houston Oral Surgeons*, 265 Ga.App. 812, 815-816, 595 S.E.2d 633, 637 (2004). "While the cardinal rule of construction is to determine the intention of the parties, no construction is required or permitted when the language employed by the parties in the contract is plain, unambiguous, and capable of only one reasonable interpretation." *Id.*

Section V of the Agreement also clearly recognizes that the provisions on cost of capital, fair value rate base, fair value rate of return, and the revenue requirement were entered into for purposes of settlement only, which means that those provisions clearly reflect the give and take of the settlement process. Recalculation of the FVROR would cancel the result achieved by the settling parties, and give APS an additional benefit not contemplated by the plain language of the Agreement.

2. The "Rate Base and Expense Effects" Have Been Appropriately Recognized under Staff's Interpretation of the Settlement Agreement.

APS argues that using the 6.09 percent return on Fair Value Rate Base ("FVRB") referenced in the Settlement Agreement would ignore "the Settlement's express intent that the Rate Rider reflect the 'rate base and expense effects'" of the acquisition."

To the contrary, the "rate base and expense effects" of the acquisition have all been appropriately recognized. Staff witness Kalbarczyk testified that, in general, APS accurately calculated and supported the other revenue requirement elements that it proposed, except for the rate of return.[53] As discussed in witness Kalbarczyk's Direct Testimony, the rate base adjustment for its additional interest in Units 4 and 5 includes three components: 1) the $52 million book value of SCE's share of the assets acquired, 2) $8,623,930 for SCE's share of the auxiliary boiler, and 3) a $254,787,074 acquisition adjustment.[54]

The Table on pages 8-9 of witness Kalbarczyk's Surrebuttal Testimony shows Staff's pro forma rate base calculations projected to June 30, 2014 and to November 30, 2014. Using APS's updated projections to November 30, 2014, which Staff accepts, the acquired plant in service (inclusive of the acquisition adjustment, the auxiliary boiler, and the deferred expenses) is $939,446,031.[55] Accumulated depreciation is $555,871,704.[56] Plant in service less accumulated depreciation is equal to $383,614,337.[57] To this amount is added deferred debits of $4,633,133 less deferred credits of $154,321,424.[58] This results in an APS rate base adjustment of $225,933,911, after APS's 96.06 allocation factor is applied, for the transaction.[59]

The expense effects of the transaction are also accounted for by APS and Staff. The Table on page 10 of Mr. Kalbarczyk's Surrebuttal Testimony shows the changes to APS's adjusted operating income resulting from the transaction. Staff accepted the updated values APS provided on April 30, 2014, which reflect a deferral period through November 30, 2014. Taking into account the expenses associated with the transaction, APS's pro forma adjustments to operating income in its as-filed case amounted to $19,617,000.[60] Assuming the deferral period extends from June 30, 2014 to November 30, 2014, the pro forma adjustment increases to $20,680,000 (a change of $1,063,000).[61] Thus, Staff

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[53] Kalbarczyk Surreb. Test., Ex. S-3 at 8.
[54] Kalbarczyk Dir. Test., Ex. S-3 at 10.
[55] Kalbarczyk Surreb. Test., Ex. S-3 at 8.
[56] *Id.* at 9.
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.* at 10.
[61] *Id.*

and APS have appropriately taken the "rate base and expense effects" into account as required by Section 10.2 of the Settlement Agreement.

APS originally calculated a $62.529 million revenue deficiency through June 30, 2014. This would result in a 2.22 percent monthly surcharge.[62] APS computed the surcharge percentage by dividing its proposed revenue requirement by the 2010 Adjusted Base Revenues from its last rate case. Staff's original proposed adjustments produced a $54,377,396 revenue deficiency and a 1.93 percent monthly surcharge rate.[63] Using the updated values through November 30, 2014, APS calculated a revenue deficiency of $65.436 million and a resulting 2.33 percent monthly surcharge.[64] Correspondingly, Staff's revenue deficiency, using updated numbers, is $57.05 million, and a surcharge rate of 2.03 percent.[65] The rate of return accounts for the difference between Staff's and APS's numbers.

B. <u>If FVROR Is the Weighted Average of the Individual Rates of Return of Specific Assets, as Asserted by APS, Then Simply Using the Weighted Average Cost of Capital Specifically for Four Corners Would Be Inappropriate.</u>

APS witness Snook states that one cannot simply "cut and paste" the 6.09 percent from Section V of the Settlement Agreement and "apply it to the new acquisition as a stand-alone asset."[66] He further states that the FVROR is asset-specific and that the overall FVROR is the weighted sum of these asset specific FVRORs.[67] He argues that use of the higher weighted average cost of capital ("WACC") is therefore appropriate.

Staff witness Kalbarczyk's Surrebuttal Testimony referred to Staff's original FVROR calculation proposed in the first phase of this case.[68] Staff's original calculation of FVROR was not based upon an analysis of individual assets with asset-specific rates of return. It was based instead upon a financial analysis of the Company's capital structure and related costs.[69] This would change if the cost of debt and equity were adjusted for this transaction.

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[62] Blankenship Dir. Test., Ex. APS-10 at 4.
[63] Kalbarczyk Dir. Test., Ex. S-2 at 7.
[64] Blankenship Reb. Test., Ex, APS-11 at 4.
[65] Kalbarczyk Surreb. Test., Ex. S-3 at 9.
[66] Snook Reb. Test., Ex. APS-5 at 3.
[67] *Id.* at 6.
[68] Kalbarczyk Surreb. Test., Ex. S-3 at 4.
[69] Kalbarczyk Surreb. Test., Ex. S-3 at 4 (Attachment RCS-2, page 12 from Ralph Smith Direct Testimony).

Further, if an asset-specific analysis is truly appropriate, as APS argues, then the Commission should reevaluate both the debt and equity components of the FVROR for this specific asset. With respect to the debt component, it is undisputed that APS incurred long-term debt in the amount of $250,000,000 at a rate of 4.725 percent specifically for APS's acquisition of SCE's interest in Four Corners Units 4 and 5.[70] If APS used this specific issuance of long-term debt to purchase this asset, it may be appropriate to use RUCO's proposed rate of return of 4.725 percent if this is truly an asset-specific analysis.

With respect to the equity component, the fact that the rate case was held open to allow for rate treatment of the Four Corners acquisition through a surcharge mechanism is a tremendous benefit to APS. This regulatory opportunity reduces APS's risk and shifts a large benefit -- which would have inured to ratepayers through the operation of regulatory lag -- to APS. APS witness Guldner agreed that the benefit essentially amounted to $65 million per year, if APS's revenue requirement calculations are used.[71] These shifts in benefits and risks should be taken into account in calculating a new asset-specific FVROR for Four Corners Units 4 and 5, if APS's position were to be adopted. Staff believes that, if APS's position were adopted, all aspects of the FVROR should be reexamined before the surcharge takes effect.[72]

Finally, APS's position again ignores the fact that the 6.09 percent FVROR was the product of a settlement between the parties. APS received a significant benefit through Section 10.3 of the Settlement Agreement. The other provisions in the settlement are part of the give and take inherent in any negotiated process.

C. <u>APS's Reliance Upon the Output of a Formula Is Misplaced.</u>

APS relies upon a formula to support its position that the rate of return used to calculate the Four Corners' revenue requirement should be 8.33 percent. According to APS, "FVROR is the output of a formula whose components will change as items are added to or subtracted from rate

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[70] Prospectus for APS $250M Debt Offering, Ex. S-5.
[71] Tr. at 125.
[72] Kalbarczyk Surreb. Test., Ex. S-3 at 7.

base."[73] APS witness Snook states, "[i]t is simply a matter of mathematics."[74] The formula that APS believes controls the FVROR for purposes of determining the Four Corners revenue requirement is:

$$\text{FVROR} = \frac{[(\text{WACC x Original Cost Rate Base}) + (1 \text{ Percent x Fair Value Increment})]}{\text{Fair Value Rate Base}}$$

APS argues that the Commission must use the specific formula and that a failure to do so would "conflict with prior ACC precedent and would fail the test of a 'reasonable return on FVRB' by a wide mark, under-recovering the WACC associated with the Four Corners transaction by some $8.3 million per year."[75]

Once again, this argument does not take into account that the FVROR of 6.09 percent approved by the Commission in Decision No. 73183 was the product of a Settlement Agreement between the parties. Under APS's position, APS would continue to receive significant value and benefit from Section 10.2 of the Agreement, but the value achieved for other parties through Section V of the Settlement Agreement with respect to FVROR would be canceled.[76]

APS relies upon *In re Arizona Water Company*, Decision No. 53537 (April 27, 1983), for the proposition that the Company must earn its WACC. However, that case did not involve a settlement agreement. In addition, that case occurred well before the *Chaparral City Water Company* case, in which the Arizona Court of Appeals determined that the Commission's method for calculating the FVROR was inappropriately determined through a "superfluous mathematical exercise."[77] *Chaparral City* resulted in the Commission reevaluating its methodology for calculating the FVROR.

APS's position would reduce the FVROR calculation to a "mathematical exercise." Accepting APS's position in this case would also mean that the fair value rate of return is "in all cases simply the by-product of a mathematical formula where the Commission does not have the ability or discretion to structure a return that is fair in any given case, and the significant discretion afforded the Commission would be severely limited."[78]

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[73] Snook Reb. Test., Ex. APS-5 at 3.
[74] *Id.* at 4.
[75] *Id.* at 8-9.
[76] Kalbarczyk Surreb. Test. Ex. S-3 at 5.
[77] *See Chaparral City Water Company v. Arizona Corporation Commission*, 1 CA-CC 05-0002 (Ariz. App. Feb. 13, 2007)(mem. decision).
[78] Kalbarczyk Surreb. Test., Ex. S-3 at 5.

In this case, APS stated that the "fair value" of this asset from an accounting "fair value" perspective is the same as the "fair value" rate base concept typically discussed in Arizona rate cases. APS witness Snook further states that, "because the asset is new to APS, the OCRB and RCND were assumed to be identical. This means that fair value rate base and original cost were also deemed to be identical."[79] Staff does not entirely agree.

According to Staff witness Kalbarczyk, the price paid by APS (including a significant acquisition adjustment) was the product of an arm's length transaction and represents the "best indicator of fair value" for purposes of determining the revenue requirement in this case.[80] It also represents the best indicator of RCND, as noted by APS witness Snook. However, it is not an accurate representation of OCRB for the reasons identified by Staff witness Kalbarczyk in the following passage from his testimony:

> It is not correct to assert that APS's approximate $226 million of acquisition value for the referenced facilities reflects the original cost value. Rather, it reflects the fair value of the facilities as acquired by APS. As explained in my direct testimony, the approximate $226 million of rate base includes an acquisition adjustment. This adjustment reflects the fact that APS paid far in excess of the $52 million book value of Units 4 & 5. The $226 million also includes over $8 million for SCE's share of the new auxiliary boiler that recently went into service.[81]

In summary, APS implies that the Commission is compelled as a matter of law to use the formula and WACC as the FVROR for Four Corners Units 4 and 5. This result, however, would be inconsistent with the discretion afforded the Commission in ratemaking matters and with the Commission's constitutional purview. The Commission is not required to use a rigid formula to determine the FVROR. If the Commission determines that the FVROR should be recalculated, the Commission should consider all relevant aspects, and should not limit itself to specific, formulaic adjustments.

D. <u>Prior Commission Precedent Supports the Staff's Position in this Case</u>.

A similar issue involving FVROR arose in the proceeding involving the 2009 rate case application filed by UNS Electric, Inc. ("UNSE"). In that case, UNSE asked the Commission to include the Black Mountain Generating Station ("BMGS") in UNSE's rate base as a post-test year

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[79] Snook Reb. Test, Ex. APS-5 at p. 7.
[80] Kalbarczyk Surreb. Test., Ex. S-3 at 6.
[81] *Id.*

rate base adjustment.[82] In Decision No. 71914, the Commission granted that request subject to certain conditions: (1) Staff evaluation of BMGS; (2) Commission determination confirming that BMGS should be included in rate base; (3) UNSE schedules showing the inclusion of BMGS in rate base, with the appropriate operating adjustments, together with a proof of revenues demonstrating that the reclassified rates will produce the same revenue as authorized herein; (4) FERC approval of UNSE's acquisition of BMGS; (5) completion of UNSE's acquisition of BMGS; and (6) customer notice requirements."[83]

In Decision No. 71914, the Commission adopted an overall weighted average cost of capital of 8.28 percent.[84] The Company proposed a FVROR of 6.88 percent, Staff proposed a FVROR of 6.01 percent, and RUCO proposed a FVROR of 5.96 percent.[85] The Commission ultimately adopted a FVROR of 6.18 percent. The Commission arrived at that number by subtracting a 2.1 percent inflation factor from the 8.28 percent WACC. The Commission determined that the resulting 6.18 percent FVROR was within the wide range of values found in the record as a result of the various methodologies used by the parties.[86]

With respect to BMGS, UNSE argued that, "because the OCRB and the replacement cost for BMGS are 'nearly identical', the Commission should use the WACC as the FVROR for BMGS. This argument is similar to APS's argument in this case.[87] The Commission rejected BMGS's argument, stating the following:

> We do not find it appropriate to use a separate FVROR with BMGS.... A Company's rate base is comprised of both new and old plant, and it would be one-sided to apply a different (higher) rate of return to only newly acquired individual items of plant.[88]

Staff submits that it would be one-sided in this case to apply a different (higher) rate of return to the newly acquired portion of SCE's interest in Four Corners Units 4 and 5.

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[82] *In the Matter of the Application of UNS Electric, Inc. for the Establishment of Just and Reasonable Rates and Charges Designed to Realize a Reasonable Rate of Return on the Fair Value of the Properties of UNS Electric, Inc. Devoted to its Operations on the Fair Value of the Properties of UNS Electric, Inc., Devoted to its Operations Throughout the State of Arizona*, Docket No. E-04204A-09-0206.
[83] Dec. No. 71914 at 13-14.
[84] *Id.* at 41.
[85] *Id.*
[86] *Id.* at 50-51.
[87] Snook Reb. Test., Ex. APS-5 at 7.
[88] Dec. No. 71914 at 52.

V. THE COMMISSION SHOULD ALLOW RECOVERY OF THE "ACQUISITION ADJUSTMENT" IN THIS CASE.

Staff supports APS's recovery of the acquisition adjustment resulting from its purchase of Four Corners Units 4 and 5. The book value (cost less accumulated depreciation) of Units 4 and 5 (including the auxiliary boiler) is approximately $60,778,500.[89] Adding the $12,963,000 for the cost of other assets related to the acquisition and deducting the $147,355,000 for the estimated cost of assumed liabilities produces a negative book value of approximately $73,613,500.[90] The difference between the cash price paid by APS for Units 4 and 5 ($181,127,000) and the negative book value of the acquired assets and liabilities ($73,613,500) represents an acquisition adjustment of approximately $254,787,393.[91] Neither Decision No. 73130 nor Decision No. 73183 addressed the appropriateness of allowing APS to recover the acquisition adjustment resulting from its purchase of SCE's interest in Units 4 and 5.

The acquisition adjustment in this case is different than the acquisition adjustments normally addressed by the Commission. In this case, APS purchased additional capacity, not of a service area or customers that it will serve.[92] In other words, APS purchased an additional interest in an asset in which it already had an interest. This is unlike the typical acquisition adjustment which results when a Company acquires an entirely new system.

In differentiating this acquisition adjustment from the typical acquisition adjustment that normally arises in cases before the Commission, APS provided the following analogy:

> A better analogy would be if water Company (A) has future water needs and has an option to purchase an existing well from Company (B) or drill a new well to serve A's customers. After evaluation, it is clear that purchasing the existing well is more advantageous than any other available option to the customer of Company A. Since the well has been serving Company B, it has depreciated its book value over several years of ownership and the book value is now below the fair market value of the well. Company A purchases the well at a fair value which is above the remaining book value of Company B, allowing the purchase to move forward and Company B to break even on the sale after all liabilities are taken into account. The difference between fair value paid by A and book value is called an acquisition adjustment per FERC. This is a significantly different circumstance than if A were to purchase all of

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[89] Kalbarczyk Dir. Test., Ex. S-2 at 13.
[90] *Id.*
[91] *Id.*
[92] *Id.* at 8.

the utility assets of B and continue to provide service to Company B customers with the same assets.[93]

Staff agrees that while the $254 million is an acquisition adjustment per se, it is different from the typical acquisition adjustment considered by the Commission. Thus, APS should be allowed recovery of the acquisition adjustment in this case.

VI. STAFF SUPPORTS APS'S AG-1 PROPOSAL IN THIS CASE.

A. Background.

AG-1 is an experimental rate schedule that was established in APS's last rate case, Decision No. 73183.[94] The program was created to allow large commercial and industrial customers to select specific third-party generation providers, who would then sell wholesale power to APS on behalf of the specific customers who have selected them.[95] APS purchases and manages the requested generation on behalf of the customers. Total program participation is limited to two hundred MW.[96] APS received customer requests to participate in the program well in excess of the two hundred MW limit, and therefore conducted a lottery as a means of equitably selecting participants.[97]

In the context of AG-1, APS has proposed to apply the Four Corners surcharge to only the non-generation portion of the AG-1 customers' bills. The AG-1 customers, by contrast, contend that they are completely exempt from the Four Corners surcharge, apparently arguing that the AG-1 rate schedule exempts them from any "generation charges." Although the AG-1 customers' argument may have some superficial appeal, an examination of the provisions of the Settlement Agreement, the AG-1 tariff, and the applicable retail rate schedules will clearly show that it is without merit.

B. Decision No. 73183 Clearly States That the Four Corners Surcharge Will Be Applied "On An Equal Percentage Basis Across All Rate Schedules."

According to Section 10.3 of the Settlement, the Four Corners adjustment rider shall be applied "on an equal percentage basis *across all rate schedules* . . . ."[98] Both Decision No. 73183 and

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[93] APS Response to Staff Data Requests 39.3, Ex. S-15.
[94] Dec. No. 73183, Ex. A at 18.
[95] Dec. No 73183 at 24.
[96] *Id.* Ex. A, attach. J at 1.
[97] *Id.* at 2.
[98] Dec. No. 73183, Ex. A at 15 (emphasis added).

the Settlement Agreement[99] specifically identify AG-1 as a rate schedule. Accordingly, there is no reason to conclude that AG-1 is exempt from Section 10.3.

AECC claims that, notwithstanding Section 10.3, the AG-1 tariff serves to specifically exclude all "generation charges" from the AG-1 rate. AECC correctly quotes a portion of AG-1, which states that "[t]he generation charges will not apply . . . ." AECC's argument assumes that the Four Corners surcharge is a "generation charge," thereby falling within AG-1's first exclusion. In other words, AECC contends that the Four Corners surcharge must be a "generation charge" because Four Corners is a generation asset.

This argument ignores the language and structure of the AG-1 tariff, as well as the language and structure of the tariffs that are eligible to participate in AG-1.[100] The term "generation charges" in AG-1 is not a general term; it is instead a specific term that refers back to the applicable retail rate schedule. In E-34, for example, the "generation charges" are specifically identified on pages 1 and 2.[101] E-34's specific "generation charges" do not include the Four Corners surcharge, nor do they include any other generation-related adjustor mechanisms.[102] The term "generation charge" in the context of E-34 is specific and narrow; that same specific and narrow "generation charge" is what is reflected in the first exclusion in AG-1.

An examination of the applicable AG-1 tariff language will illustrate this point. That tariff states that *"[a]ll provisions, charges and adjustments in the customer's applicable retail rate schedule will continue to apply,"* with the exception of four specific exclusions:[103]

> 1. *The generation charges will not apply;*
>
> 2. *Adjustment Schedule PSA-1 will not apply,* except that the Historical Component will apply for the first twelve months of service under this rate rider;
>
> 3. *Adjustment Schedule EIS will not apply;* and

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[99] *Id.* at 18.

[100] The large commercial and industrial tariffs eligible to participate in AG-1 are E-34, E-35, E-32 L, and E-32 TOU L. Dec. No. 73183, Ex. A, attach. J at 1.

[101] ALJ Jibilian took Official Notice of E-34 during the hearing; Tr. at 158.

[102] E-34 at 1-2.

[103] Dec. No. 73183, Ex. A, attach. J at 4 (emphasis added).

4. The applicable proportionate part of any taxes or governmental impositions which are or may in the future be assessed on the basis of gross revenues of the Company and/or the price or revenue from the electric energy or service sold and/or the volume of energy generated or purchased for sale and/or sold hereunder shall be applied to the customer's bill.[104]

The four listed excluded items from AG-1, set forth above, specifically refer back to the applicable retail tariffs. E-34, for example, lists the Power Supply Adjustor ("PSA") and the Environmental Improvement Surcharge ("EIS") separately from the generation charges; AG-1 lists the PSA and the EIS as independent exclusions.[105] This parallel is significant because both the PSA and the EIS are generation-related mechanisms.[106]

If AECC's arguments were correct, and the term "generation charges" in AG-1 includes anything that is merely related to generation, it would not be necessary to specifically list the PSA and the EIS in AG-1's exclusions. Because some generation-related mechanisms (the PSA and the EIS) are specifically excluded from AG-1, it is reasonable to conclude that the term "generation charges" is not comprehensive, but is instead specific. In this instance, the term "generation charges" refers back to the applicable retail tariffs; on those retail tariffs, the term "generation charges" clearly does not include the Four Corners surcharge. As a result, AG-1's exclusion of "generation charges" does not capture Section 10.3.

C. <u>The Commission's Order and the Settlement Agreement are the Controlling Documents.</u>

The AG-1 customers imply that the Commission should adopt their interpretation because their representatives were present during the settlement negotiations. The Commission, however, should not give such extrinsic evidence any significant weight because the parties memorialized their agreement in a written document. The provisions of the Settlement Agreement and the applicable tariffs are clear, and there is no need for additional evidence.

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[104] *Id.* (emphasis added).
[105] E-34 at 3.
[106] Dec. No. 73183, Ex. A at Sec. VIII, XI.

D. APS's Proposal is Reasonable under the Circumstances.

Based upon the Settlement and the AG-1 tariff, one could easily argue that the applicable provisions contemplate an equal spread across all rate schedules, including AG-1. By contrast, Staff believes that it is difficult to conclude that the AG-1 tariff was intended to be completely excluded from the Four Corners surcharge. APS's proposal, in light of the express provisions of the settlement and the applicable tariffs, can be viewed as a fair result. Staff believes that APS's proposal is not unreasonable, and as Staff's witness testified, it is consistent with the spirit and the purpose of AG-1.[107]

RESPECTFULLY SUBMITTED this 29th day of August, 2014.

Maureen Scott

Maureen A. Scott, Senior Staff Counsel
Charles H. Hains, Attorney
Janet Wagner, Assistant Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

Original and thirteen (13) copies
of the foregoing filed this
29th day of August, 2014 with:

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

Copies of the foregoing mailed this
29th day of August, 2014 to:

Melissa M. Krueger
Thomas L. Mumaw
Pinnacle West Capital Corporation
400 North 5th Street, MS 8695
Phoenix, Arizona 85004
Attorneys for Arizona Public Service Company

C. Webb Crockett
Patrick J. Black
Fennemore Craig, PC
2394 East Camelback Road, Suite 600
Phoenix, Arizona 85016
Attorneys for Freeport-McMoRan and Arizonans for Electric Choice and Competition (AECC)

---

[107] Kalbarczyk Surrb. Test., Ex. S-3 at 11.

Daniel W. Pozefsky, Chief Counsel
Residential Utility Consumer Office
1110 West Washington, Suite 220
Phoenix, Arizona 85007
Attorneys for RUCO

Michael A. Curtis
William P. Sullivan
Curtis, Goodwin, Sullivan,
Udall & Schwab, PLC.
501 East Thomas Road
Phoenix, Arizona 85012-3205
Attorneys for the Town of Wickenburg and Town of Gilbert

Timothy M. Hogan
Arizona Center for Law in the Public Interest
202 East McDowell Road, Suite 153
Phoenix, Arizona 85004
Attorneys for WRA, SWEEP, ASBA/AASBO

Jeff Schlegel
SWEEP Arizona Representative
1167 West Samalayuca Drive
Tucson, Arizona 85704

David Berry
Western Resource Advocates
Post Office Box 1064
Scottsdale, Arizona 85252-1064

Barbara Wyllie-Pecora
14410 West Gunsight Drive
Sun City West, Arizona 85375
Kurt Boehm

Jody M. Kyler
Boehm, Kurtz & Lowry
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Attorneys for The Kroger Co.

Jeffrey W. Crockett, Esq.
Brownstein Hyatt Farber Schreck LLP
One East Washington Street, Suite 2400
Phoenix, Arizona 85004
Attorneys for Arizona Association of Realtors

Michael W. Patten
Roshka DeWulf & Patten, PLC
One Arizona Center
400 East Van Buren Street, Suite 800
Phoenix, Arizona 85004
Attorneys for Tucson Electric Power Company

Bradley S. Carroll
UniSource Energy Services
Legal Department - MS HQE 910
Post Office Box 711
Tucson, Arizona 85702

Cynthia Zwick
1940 East Luke Avenue
Phoenix, Arizona 85016

Michael M. Grant
Gallagher & Kennedy, PA
2575 East Camelback Road
Phoenix, Arizona 85016-9225
Attorneys for AIC

Gary Yaquinto, President & CEO
Arizona Investment Council
2100 North Central Avenue, Suite 210
Phoenix, Arizona 85004

Karen S. White
Samuel T. Miller
Air Force Utility Law Field Support Center
AFLOA/JACL-ULFSC
139 Barnes Drive
Tyndall AFB, Florida 32403

Greg Patterson, Of Counsel
Munger Chadwick
2398 East Camelback Road, Suite 240
Phoenix, Arizona 85016
Attorneys for Arizona Competitive Power Alliance

Nicholas J. Enoch
Jarrett J. Haskovec
Lubin & Enoch, PC
349 North Fourth Avenue
Phoenix, Arizona 85003
Attorneys for IBEW Locals 387, 640 & 769

Lawrence V. Robertson, Jr.
Post Office Box 1448
Tubac, Arizona 85646
Attorney for Southwestern Power Group II, LLC; Bowie Power Station, LLC; Noble Americas Energy Solutions LLC; Constellation NewEnergy, Inc.; Direct Energy, LLC and Shell Energy North America (US), LP

Laura E. Sanchez
Natural Resources Defense Council
Post Office Box 65623
Albuquerque, New Mexico 87193

Jay I. Moyes
Steve Wene
Moyes Sellers & Hendricks
1850 North Central Avenue, Suite 1100
Phoenix, Arizona 85004
Attorneys for AzAg Group

Jeffrey J. Woner
K.R. Saline & Assoc., PLC
160 North Pasadena, Suite 101
Mesa, Arizona 85201

Scott S. Wakefield
Ridenour, Hienton & Lewis, PLLC
201 North Central Avenue, Suite 3300
Phoenix, Arizona 85004-1052
Attorneys for Wal-Mart Stores, Inc.

Steve W. Chriss
Senior Manager, Energy Regulatory Analysis
Wal-Mart Stores, Inc.
2011 S.E. 10^{th} Street
Bentonville, Arkansas 72716-0550

Craig A. Marks
Craig A. Marks, PLC
10645 North Tatum Boulevard
Suite 200-676
Phoenix, Arizona 85028
Attorney for AARP

John Moore, Jr.
7321 North 16^{th} Street
Phoenix, Arizona 85020

Douglas V. Fant
Law Offices of Douglas V. Fant
3655 West Anthem Way
Suite A-109, PMB 411
Anthem, Arizona 85086

Amanda Ormond
Southwest Representative
Interwest Energy Alliance
7650 South McClintock Drive
Suite 103-282
Tempe, Arizona 85284

Travis Ritchie
Nellis Kennedy-Howard
Sierra Club Environmental Law Program
85 Second Street, 2^{nd} Floor
San Francisco, California 94105

Monica A. Martz