BEFORE THE ARIZONA CORPORATION C

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY – REVISED LINE EXTENSION TARIFF SCHEDULE 3	DOCKET NOS. E-01345A-05-0816 E-01345A-05-0826 E-01345A-05-0827

EXCEPTIONS OF ARIZONA PUBLIC SERVICE COMPANY TO STAFF RECOMMENDED ORDER

Arizona Public Service Company ("APS" or "Company") hereby submits to the Arizona Corporation Commission ("Commission") its Exceptions to the Recommended Order attached to the Utilities Division Staff ("Staff") Memorandum dated November 2, 2007. The Recommended Order approves the Company's revised Schedule 3 – "Line Extensions" – with one critical exception. Specifically, the Recommended Order mandates that all proceeds received by APS pursuant to the schedule be accounted for as "contributions-in-aid of construction" ("CIAC") rather than as Miscellaneous Service Revenues. Treatment of these proceeds as CIAC will result in a substantial loss of potential benefits to APS and its customers, while producing no offsetting reductions in the cost to new applicants of receiving service from the Company.

Revised Schedule 3 presents the Commission with a unique regulatory opportunity – the opportunity to significantly and unilaterally reduce future APS rate requests. No need to depend upon lower gas and power prices, lower interest rates, or some other exogenous cost of service factor to have that same result. Rather the Commission can itself accomplish this benefit for APS customers by seizing upon the opportunity presented in the Company's October 24th filing and approving APS' requested revenue accounting treatment of Schedule 3 proceeds.

BACKGROUND

Treating certain Schedule 3 proceeds as revenue has always been a part of APS's line extension policy. Prior to July 1, 2007, the Company's line extension policy provided so-called "free footage" allowances for new residential applicants for service. During that time, proceeds from Schedule 3 took one of three forms, which determined its accounting treatment. Costs in excess of such "free" allowances were advanced by the applicant to APS and refundable, either in whole or in part, under certain circumstances. Non-residential applicants were subject to a more complicated set of rules involving the conduct of an economic feasibility study ("EFS"). Costs in excess of those shown to be justified under the EFS were required to be contributed to APS on what was generally a non-refundable basis. In addition, applicants for new service could be required to pay APS a "facilities fee," again based on the results of an EFS.[1] These three different forms of payment to APS for the extension of new or expanded facilities were accounted for as advances-in-aid of construction ("Advances"), CIAC and revenue, respectively.

As part of its last general rate case filing, APS proposed to convert the "free footage" allowance into a flat $5,000 "equipment allowance" and clarify certain of the refund provisions of Schedule 3. Decision No. 69663 required APS to file for Commission approval a revised Schedule 3 eliminating all footage and equipment allowances and any requirement for or use of an EFS to determine the charges to new service applicants. *See* Decision No. 69663 at 156. These changes effectively eliminated the previous accounting distinctions made in Schedule 3 between Advances, CIAC and revenue, resulting in a single combined payment from all applicants to APS equal to the cost of extending or expanding electric distribution facilities. Decision No. 69663 did not specify by its terms exactly how APS was to account for such proceeds, but APS firmly believes its proposed accounting treatment (i.e., as revenues) is most consistent with the expressed intent of the Commission that Schedule 3

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[1] There were special provisions for certain types of applicants such as irrigation and "temporary" service customers, but the above description encompassed 99% plus of new service applicants.

should be amended to make growth pay a portion of the higher costs that would otherwise be imposed on APS customers.

APS submitted a revised Schedule 3 on July 27, 2007 and provided a further revised version of Schedule 3 on October 24, 2007. It is this second revision that is before the Commission and the subject of Staff's Memorandum and Recommended Order.

SCHEDULE 3 PROCEEDS SHOULD BE ACCOUNTED FOR AS REVENUE

In its letter to the Commission dated October 24, 2007, which accompanied the revised Schedule 3 filing now under consideration, APS explained both how and why it proposed that the Commission effectuate its intent in Decision No. 69663 by authorizing and directing APS to account for all proceeds received under Schedule 3 as revenues. A copy of that letter is attached to these Exceptions. Without repeating all the discussion and analysis set forth in the attached letter, APS would reiterate the following points:

1. Treating Schedule 3 proceeds as revenue will provide a dollar-for-dollar reduction of future rate increases to APS customers. Treating them as CIAC does result in a rate base deduction, *but one that translates into a much smaller (roughly 12 cents) reduction in future revenue requirements for every dollar of Schedule 3 proceeds*. This is illustrated by the chart provided in the October 24th letter:

Comparison of Accounting Treatment for Schedule 3 Proceeds

Treatment as CIAC:		
Schedule 3 Fees Treated as CIAC	$	500,000
Less: Income Tax (40%)		200,000
Net Reduction to Rate Base	$	300,000
Cost of Capital Reduction (including Income Taxes)	$	(36,210)
Depreciation Expense Reduction		(16,667)
Property Tax Expense Reduction		(7,500)[2]
Reduction to Revenue Requirement due to CIAC Treatment	**$**	**(60,377)**
Treatment as Revenue:		
Schedule 3 Fees Treated as Revenue	$	500,000
Reduction to Revenue Requirement due to Revenue Credit Treatment	**$**	**(500,000)**

[2] This reflects current state tax provisions

2. Treating Schedule 3 proceeds as revenues rather than CIAC does NOT result in any "double-recovery" of costs by APS. APS recovers its costs just once in either scenario excepting under the CIAC, a far larger portion of those costs is borne by APS customers in rates rather than by growth.

3. Looking beyond just the next rate proceeding, the decision to treat Schedule 3 proceeds as revenue continues to benefit customers in future years in the form of lower rates.

4. Treating Schedule 3 proceeds as revenues improves APS's creditworthiness because it *increases* APS' FFO/Debt ratio. Treating such proceeds as CIAC weakens APS's creditworthiness because it *decreases* APS' FFO/Debt ratio. Given the current volatile state of credit markets, key financial metrics such as FFO/Debt have taken on even greater importance in determining access to credit upon reasonable terms.

5. The improvement in APS's financial performance from treating Schedule 3 proceeds as revenue allows the Company to finance, through debt and equity, additional new infrastructure beyond that encompassed by Schedule 3. Conversely, CIAC produces no additional financing capability and may actually erode the Company's existing capacity to fund new infrastructure.

As noted above, Decision No. 69663 did not expressly mention the accounting treatment of such proceeds. It is not, however, in any way silent concerning the intent of the ordered changes to Schedule 3:

> We agree with Staff that the Commission should use the generic [hook-up fee] docket to gather information useful in evaluating the feasibility of hook-up fees for electric and gas utilities. In the interim, however, we find that, in view of the unprecedented growth in APS' service territory, granting APS variances to A.A.C. R14-2-207.C.1 and C.2, which require a company to provide a specified footage of distribution line at no

> charge, is a necessary and appropriate measure *to shift the burden of rising distribution infrastructure costs away from the current customer base to growth*. [*Id.* at 97. Emphasis supplied.]

At the Open Meeting at which Decision No. 69663 was entered, the discussion over the Chairman Gleason and Commissioner Mayes amendments regarding the intent of proposed changes to Schedule 3 was similarly unambiguous:

> <u>Commissioner Mayes</u>: We're looking to go toward a hook-up fee situation, which we ask growth to pay for itself. [Open Meeting Tr. Vol. III at 577.]

> <u>Chairman Gleason</u>: In other words, someone has to pay for that, that footage, and you either pay for it, you know, up front, or its gets put into a main extension agreement or something like that. [Open Meeting Tr. Vol. III at 569.]

Later, Commissioner Pierce added:

> <u>Commissioner Pierce</u>: I am not opposed to growth, but I am opposed to giving growth a free ride on the backs of current ratepayers. Growth should pay its own way. APS needs to bring this Commission a proposal that addresses its cash flow concerns in a way that does not result in current ratepayers subsidizing future ratepayers. [Open Meeting Tr. Vol. V at 1036.]

Moreover, even the potential classification of Schedule 3 proceeds as revenue was discussed on several occasions during the course of the hearing resulting in Decision No. 69663:

> <u>Commissioner Mayes</u>: And do we know, how much would that save us if we eliminated that $5,000 allowance for single-family homes and residential homebuilder subdivisions? Do we know what that would - - what kind of *revenue* that would free up or provide? [Hearing Tr. Vol. XX at 3782. Emphasis supplied.]

At a subsequent portion of the hearing, the issue resurfaced again:

> <u>Commissioner Mayes</u>: Let's say hypothetically we have determined a way of generating *revenues* associated with growth and new housing developments *that did not have negative implications for your FFO to debt ratio*. And assuming that that *income* was approximately $84 million per year, which is what I think we determined a $2,000 hook-up fee would bring in for the company, that *revenue* would help the company deal with some of its construction needs, wouldn't it?

> <u>APS witness Don Robinson</u>: Well, if we had $84 million coming in, that's obviously a help. [Hearing Tr. Vol. XXVI at 4895. Emphasis supplied.]

And even prior to the hearing, Commissioner Mundell had placed a letter into the docket that admonished the parties:

> We need to "think outside the box." Given the significant peak load growth rate that APS is experiencing and the amount of CapEx necessary to meet that load, I think it is time to explore the option of using hook-up fees so that existing customers are not continually subject to exorbitant rate increases. [Commissioner Mundell Letter dated March 28, 2006.]

A few months later, Commissioner Hatch-Miller also filed a letter stating, in relevant part:

> As you know, APS is tasked with funding an enormous CAPEX budget of $3.1 billion over the next five years for generation, transmission and distribution projects. These improvements are presumed necessary to ensure the adequacy and reliability of electric service in addition to meeting estimated load growth of 4 percent per year. A portion of your company's [APS's] CAPEX budget will be funded by the bond market. Your ratepayers stand to save money in long-term borrowing costs in your credit ratings hold or improve.
>
> Based on the S&P report, please provide testimony on *what measures the Commission could take in helping APS gradually improve its creditworthiness*. [Commissioner Hatch-Miller Letter of July 21, 2006 – Attachment DEB-11RB to APS Exhibit No. 5. Emphasis supplied.]

Although Schedule 3 is not a "hook-up" fee, APS has tried to nevertheless "think outside the box" on how the Commission might best accomplish the goals of defraying future APS electric rate increases and also improving the Company's credit worthiness. Treatment of Schedule 3 proceeds as revenue meets both those criteria and is therefore entirely consistent with the Commission's objectives as stated throughout the various stages of this proceeding. And it does so without changing the dollar amount that new service applicants will pay under Schedule 3 or raising any of the rates already approved by Decision No. 69663.

In the Staff Memorandum, Staff states that: "discussion of the accounting treatment of payments should not be included in the tariff [Schedule 3] because *it goes beyond what is required or authorized by Decision No. 69663*." Staff Memorandum at 1. (Emphasis supplied.) But so does the Staff's proposal for CIAC treatment. The problem with Staff's argument is that the precise language of Decision No. 69663 did not "require or authorize" *any* specific accounting treatment for the new "single bucket" of Schedule 3 proceeds. Staff's proposal, that the Commission now "require and authorize" the payments to be recorded as CIAC, [3] therefore suffers the identical alleged "problem" that forms the basis for Staff's sole

[3] Staff uses the specific words "continue to be treated as Contributions in Aid of Construction ("CIAC")." Recommended Order at 2. As discussed above, payments received under the previous version of Schedule 3 were treated as Advances, CIAC and revenue, depending on the terms of the payment and the specific provisions of that Schedule. Thus, the suggestion that there was some form of uniform accounting treatment of Schedule 3 proceeds that is somehow just being "continued" is factually inaccurate.

objection to APS's filing. APS fails to understand how its proposal can be deemed as going beyond the scope of a compliance filing while Staff's competing CIAC proposal does not.

In point of fact, BOTH Staff and APS are attempting to clarify the Commission's intent in Decision No. 69663, given that decision does not explicitly detail the accounting treatment to be afforded Schedule 3 proceeds. It is up to the Commission to determine which proposal best does so.

Staff's Memorandum does not appear to dispute any of the substantive arguments presented by APS for revenue treatment of Schedule 3 proceeds. Rather, the Memorandum simply suggests that this issue be raised in "a separate filing." *Id.* However, this is precisely what the Company did in its October 24th filing of a revised Schedule 3, as ordered by Decision No. 69663, which Decision was itself made in a general rate proceeding of the type alluded to in the Staff Memorandum.

Again, the Company's suggested accounting treatment of Schedule 3 proceeds will not affect, in even the slightest manner, the dollar amount that applicants for APS service will have to pay under Schedule 3. APS's proposed Schedule 3 will not raise a dime more or less than that Schedule suggested by Staff in the Recommended Order. However, although APS's accounting treatment of Schedule 3 payments is inconsequential to new service applicants such as the homebuilders and real estate developers, this accounting for Schedule 3 proceeds issue is very critical to both APS and its customers for all of the reasons set forth above and in the Company's letter to the Commission of October 24th. Attached to these Exceptions is a proposed amendment to the Recommended Order that would approve Schedule 3 as filed by the Company on October 24, 2007 and would direct that APS account for the proceeds as above-the-line operating revenues.

CONCLUSION

It is said that nothing in life is more expensive than a missed opportunity. One way or the other, a decision will be made by the Commission concerning the accounting for proceeds under Schedule 3. A decision to treat them as revenues will bring significant advantages to

APS and its customers at no additional cost to new service applicants and without raising existing APS electric rates so much as a penny. A decision to treat them as CIAC will forego those advantages, with no offsetting benefit to anyone. In such a case, the "missed opportunity" presented by the Company's October 24th filing will indeed prove quite expensive.

RESPECTFULLY SUBMITTED this 16th day of November, 2007.

PINNACLE WEST CAPITAL CORPORATION

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Original and 13 copies of the foregoing were filed this 16th day of November, 2007 with:

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All Parties of Record