BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner
JEFF HATCH-MILLER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN K. MAYES
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, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND FOR APPROVAL OF PURCHASED POWER CONTRACT	)	DOCKET NO. E-01345A-03-0437

DIRECT TESIMONY

IN SUPPORT OF THE PROPOSED SETTLEMENT AGREEMENT

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ARIZONA CORPORATION COMMISSION

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Ms. Jaress' testimony summarizes sections of the proposed Settlement Agreement, discusses some of the differences among the parties' positions as set forth in their direct testimony and how the differences were resolved within the Settlement Agreement. She sets forth revenue requirement changes reflected in the Settlement Agreement that resulted in Staff's support of a rate increase and explains how those changes were based on the resolution of both revenue impacting and non-revenue impacting issues.

Ms. Jaress' testimony shows how many of the benefits set forth in the Settlement Agreement are long-term and will be experienced by APS customers far beyond the resolution of this rate case. Finally, Ms. Jaress makes clear why it is in the public interest for the Commission to approve the Settlement Agreement.

ACRONYMS

ACAA - Arizona Community Action Association - An organization that finds avenues of economic self-sufficiency for low-income Arizonans.

AECC - Arizonans for Electric Choice and Competition. A coalition of businesses that advocates on behalf of retail electric customers and supports the advancement of retail competition.

AUIA - Arizona Utility Investors Association. Represents the interests of equity owners and bondholders of Arizona Utilities.

CN&SE - Constellation NewEnergy, Inc. and Strategic Energy, LLC.

COSS - Cost of Service Study

FEA - Federal Executive Agencies. Represents all federal facilities served by APS, two of the largest being Luke Air Force Base and the Marine Corps Air Station in Yuma.

OATT - Open Access Transmission Tariff

PSA - Power Supply Adjustor

RUCO - Residential Utility Consumer Office. Represents the interests of Arizona residential utility ratepayers in rate-related proceedings before the Arizona Corporation Commission.

SWEEP - The Southwest Energy Efficiency Project – A public interest organization dedicated to advancing energy efficiency in southwestern states.

TCA - Transmission Cost Adjustor

WRA – Western Resource Advocates. An environmental law and policy organization dedicated to restoring and protecting the natural environment of the Interior American West.

INTRODUCTION

Q. Please state your name, occupation, and business address.

A. My name is Linda A. Jaress. I am an Executive Consultant III in the Utilities Division of the Arizona Corporation Commission ("ACC" or "Commission"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

Q. Did you provide direct testimony in this docket?

A. Yes. My direct testimony was filed on February 9, 2004. I also provided an Addendum to my direct testimony on February 23, 2004.

Q. What is the purpose of this testimony?

A. The purpose of this testimony is to explain why approval of the Settlement Agreement is in the public interest and why Staff entered the Agreement.

THE SETTLEMENT AGREEMENT

Q. Why is the Settlement Agreement in this case in the public interest?

A. The parties to the case represent a true cross-section of the public. Residential, low income, commercial and industrial customers, military bases, utility investors, environmentalists, merchant plants, and supporters of distributed generation and solar generation all were zealously represented during the negotiation process. The Agreement that resulted from the negotiations of these parties represents their best efforts to resolve differences which are unlikely to be resolved to their satisfaction in a litigated rate case proceeding.

The Settlement Agreement is in the public interest not only because it represents a consensus of the vast majority of the parties, but also because it provides long-term benefits to the customers of APS and the citizens of Arizona. For example, the reduction in the value of the Pinnacle West Energy Corporation assets, explained below, is recommended not just for adoption in this case but as a permanent reduction. This would benefit customers for many years, until the assets are fully depreciated. The proposed increase in Demand Side Management spending would have long-term effects on the reduction in APS' need for new generation. The provision requiring APS to issue a special RFP for renewables in 2005 is a positive step toward providing long-term improvements to the natural environment in Arizona

Staff, then, believes that adoption of the Settlement Agreement in its entirety by the Commission would provide long-term benefits to every party to the Agreement and to the people of Arizona. We further believe that the resulting revenue requirement is fair and that it is in the public interest for the Commission to approve the Settlement Agreement in its entirety.

REVENUE REQUIREMENT

Q. Please summarize APS' original request for a rate increase and the parties' testimony in response.

A. On June 27, 2003, APS filed an application to increase revenues from its customers by $175.1 million including a proposed additional surcharge of $8.3 million, which represents the Competition Rules Compliance Charge ("CRCC"). Staff's direct testimony, filed in February, 2004, recommended a net reduction of $142.7 million which included a $7.4 million CRCC surcharge. The direct testimony of the Residential Utility Consumer Office ("RUCO") supported a decrease of $53.61 million. Arizonans for Choice and Competition ("AECC"), representing businesses who support the advancement of retail competition, recommended adjustments to APS' request that resulted in a revenue requirement increase of approximately $25.0 million. Ultimately, the parties agreed to a base rate increase of $67.6 million with an additional CRCC surcharge of $7.9 million, for a total increase of $75.5 million.

Q. Please explain how the ultimate revenue requirement of $75.5 million was determined.

A. As mentioned in the testimony of Mr. Ernest Johnson, the settlement process was a give and take process. The resolution of issues was rarely conducted on a "this for that" basis but usually centered around groups of issues or discrete issues, always with attention paid to the Agreement as a whole. Although some issues (such as the treatment of the PWEC assets) had direct effects on revenue requirement, others (such as rate design) did not have a direct effect but may have had an impact on the overall revenue requirement negotiations. In summary, it is difficult to discuss and explain individual issues in isolation. The Agreement is best understood as a comprehensive resolution to interrelated issues.

Q. What are the most significant differences between the Settlement Agreement and Staff's direct testimony?

A. Certainly the issue that had the greatest impact on the movement from Staff's revenue requirement recommendation in its direct case to the revenue requirement in the Settlement Agreement was the transfer and inclusion of certain Pinnacle West Energy Corporation ("PWEC") generation assets in APS' rate base, at the reduced value that will be discussed below. The revenue requirement impact from this change was approximately $76 million.

The adoption by the Settlement Agreement of more current fuel, purchased power expenses and off-system sales margins, as presented in APS' rebuttal testimony, increased the revenue requirement by approximately $34 million. The negotiated capital structure and cost of debt and equity levels also had a significant effect, increasing the revenue requirement from Staff's original proposal by approximately $35 million. Similarly, the resolution of depreciation issues and nuclear decommissioning expense issues resulted in an increase to Staff's revenue requirement position of approximately $33 million.

Q. Do the adjustments related to these five issues total the entire change from Staff's direct testimony?

A. No. Although these issues cause discrete, dollar impacts on the revenue requirement, they do not total the entire difference between Staff's testimony and the proposed revenue requirement. The revenue requirement reflected in the Agreement is derived as a result of consideration of specific revenue impacting adjustments <u>and</u> non-revenue impacting adjustments. The revenue requirement does not represent Staff's or any party's assent or dissent to any particular level of cost or expense not specifically set forth in the Agreement, but instead, represents part of the compromise that occurred over the course of these negotiations.

Q. Does Staff's concurrence with the Settlement Agreement revenue requirement mean that Staff concluded that it could not support its direct case?

A. No, it does not. Staff's concurrence means that, taken as a whole, Staff believes that the settlement agreement will provide sufficient other benefits to ratepayers and the general public to counterbalance the increased level of the revenue requirement.

PWEC ASSETS AND ELECTRIC COMPETITION

Q. The most controversial issue with the largest impact on revenue requirement and on the future of electric competition in Arizona is the transfer and rate base treatment of the generating plants owned by APS' affiliate, Pinnacle West Energy Corporation ("PWEC"). What were the parties' original positions?

A. In its direct case, APS requested the transfer and ratebasing of the PWEC assets at book value, which was then nearly $900 million. Staff's testimony suggested that APS had not justified inclusion of the plants in its rate base and did not recommend either the transfer or ratebasing of those assets. RUCO's testimony asserted that APS had not performed the appropriate studies to determine if the acquisition of the PWEC assets was the "least cost" option for acquiring plant and recommended that the Commission deny APS' request to transfer the PWEC assets or include them in APS' rate base until that was determined. RUCO also recommended that the case be bifurcated and extended for a separate proceeding to further evaluate the PWEC assets. AECC, the Arizona Competitive Power Alliance ("the Alliance"), Constellation NewEnergy, Inc., and Strategic Energy, L.L.C. ("CN&SE") all strongly recommended denial of the transfer and ratebasing of the PWEC assets.

There was also substantial testimony regarding the status of electric restructuring in Arizona filed by several parties. Among the positions put forth, RUCO urged the Commission to scrap electric restructuring completely. The Arizona Community Action Association ("ACAA"), which represents low-income customers, urged the Commission to protect low-income customers from bearing the cost of rectifying the electric restructuring that they had opposed. Other parties filed testimony on the damage that transferring the PWEC assets to APS would cause the electricity market in Arizona.

Q. How will those various parties and the public benefit from the PWEC asset treatment proposed by the Settlement Agreement?

A. The benefits that would be realized by those who were originally opposed to the transfer and ratebasing of the PWEC assets include the retention of the Track B benefits, the removal of uncertainty regarding APS' role in electric competition in Arizona, and the creation of opportunities to sell power to APS.

Q. At what value did the parties agree to include the PWEC assets in rate base and why?

A. APS originally requested recovery of $889.2 in rate base for the PWEC assets as of the end of the 2002 test year. However, as time passed and the plant depreciated, the book value was expected to fall to $848.0 million at December 31, 2004. The parties agreed that the plants would be ratebased at $700.0 million.

Q. What does the difference between $848.0 million and $700.0 million represent?

A. APS is currently under contract with PWEC to purchase electricity from all but one of PWEC's generating units ("the Track B contract"). Staff and other parties believe that the terms of that contract are beneficial to APS customers and that those benefits should be retained as long as possible. Thus, a reduction in the value of the PWEC assets that fairly represents the benefits from the Track B contract was negotiated. This is a permanent reduction to the rate base that will benefit customers long after the Track B contract would have expired.

Q. What impact will the transfer of the PWEC assets have on electric competition in Arizona?

A. Although the Agreement proposes to transfer and rate base the PWEC assets, which APS requested, it also proposes actions to counteract any perceived detriment to electric competition in Arizona that the transfer could cause. For example, APS has agreed not to self-build generation for ten years (unless certain, specific circumstances occur), allowing the merchant electric industry opportunities to supply some of APS' generation needs. Also, APS agreed to issue an RFP during 2005 seeking long-term resources of 1000 MW or more for 2007 and beyond. This solicitation will further support the development of a competitive electricity market in Arizona.

The road that electric competition has traveled in Arizona has been rocky. However, Staff believes that adoption of the Settlement Agreement will enable smoother traveling. The combination of the transfer of the PWEC assets (at a reduced value) to APS, along with the ten-year prohibition against self-building and the issuance by APS of an RFP for a significant amount of power will enhance the potential development of electric competition in Arizona. Finally, adoption of these segments of the Agreement by the Commission will likely eliminate potential appeals, contribute to the protection of the financial health of one of Arizona's largest corporations and employers, and promote the development of the market for merchant electricity.

POWER SUPPLY ADJUSTOR

Q. Although the Power Supply Adjustor ("PSA") does not contribute to the level of the negotiated increase, it is an important issue. Provide some background on this issue.

A. In a previous docket culminating in Decision No. 66567, dated November 18, 2003, Staff did not oppose approval of a PSA for APS that included recovery of both fuel and purchased power expenses. In that Decision, the Commission rejected the concept of including fuel in the adjustor and did not approve Staff's request for an earnings test to ensure that APS does not over-collect. The Decision was clear in its intent to approve the "concept" of a Purchased Power Adjustor yet deferred final "affirmative approval" to this APS rate case.

Q. What were the parties' positions on a PSA in their direct testimony in this case?

A. APS continued to request a PSA. In contrast, RUCO recommended that a purchased power and fuel adjustor be denied. Staff recommended denial of a PSA based on its concern that ratepayers would not experience the reductions in APS' non-fuel cost of service (those costs not included in the adjustment mechanism), but would at the same time bear increasing variable power costs through the adjustor. However, Staff maintained its previous contention that, if the Commission were to approve an adjustor, APS should recover fuel costs along with purchased power expenses.

Q. How does the Settlement Agreement address the adjustor issue?

A. The Settlement Agreement proposes an adjustor similar to that favored by Staff in the Adjustor case with some differences. The adjustor included in the Agreement proposes at least a five-year life instead of the three-year life proposed by Staff in the Adjustor case. It does not include the earnings test that Staff had previously recommended and the Commission denied. However, the proposed PSA contains reporting requirements that are significant. Detailed monthly reports, some publicly available and some not, will provide Staff and RUCO with comprehensive information regarding the operation of each generation plant and each fuel and power purchase in order to enhance Staff's ability to track and determine the appropriateness of APS' fuel and power purchases.

Q. In the Adjustor case decision, the Commission asked "the parties in APS' pending rate case to work on developing a symmetrical incentive or performance based rate ("PBR") mechanism." Did the parties accomplish this request?

A. Yes, they did. On page 4 of the proposed Agreement, the parties agreed that within the PSA, "[t]here shall be an incentive mechanism where APS and its customers shall share in the costs or savings. The percentage of sharing shall be ninety (90) percent for the customers and ten (10) percent for APS with no maximum sharing amount." This, in effect, creates a deadband whereby ten percent of the fuel and purchased power costs that exceed base power costs will be absorbed by the Company; similarly, ten percent of any fuel and purchased power savings will be absorbed by the Company.

Q. What are the benefits of this mechanism?

A. APS will benefit by diminished risk related to volatile purchased power and fuel costs. Customers will benefit because the recommended incentive mechanism should motivate APS to reduce fuel and purchased power costs below their current level.

Q. Did this adjustor affect revenue requirements?

A. Although the PSA does not directly affect revenue requirement, the parties agreed to set the base cost of fuel and purchased power on APS' recent costs, which were higher than those in the test year. This was done partially to recognize recent cost levels and partially to reduce the risk that the adjustor will need to be raised significantly at the end of its first year of existence.

DEPRECIATION

Q. Twenty-one pages of the Appendices to the proposed Agreement list depreciation rates, service lives and net salvage values. Why is it necessary for depreciation issues to be settled and for the Commission to expressly approve depreciation rates, service lives and net salvage values?

A. If new depreciation rates, service lives and net salvage values are not expressly approved by the Commission, then whatever rates, lives and values were last approved would remain in place.

Q. Which parties supplied depreciation testimony in the direct case?

A. Only APS and Staff supplied such testimony.

Q. When were APS' current depreciation rates adopted?

A. APS' current depreciation rates were approved on February 14, 1995. That change in depreciation rates represented an update of a 1992 depreciation study approved by the Commission in June, 1994.

Q. What adjustments to test year depreciation did the parties make in the direct case?

A. APS requested approval of a $3.0 million increase in depreciation expense, Staff requested a $44.3 million decrease, and RUCO made no adjustment to depreciation expense related to depreciation rates, asset lives and salvage values.

Q. What is SFAS No. 143, and what is its relevance to this rate case?

A. As discussed in direct and rebuttal testimony, the Financial Accounting Standards Board ("FASB") issued a statement (SFAS No. 143), which was implemented on January 1, 2003, one day after the end of the test year in this case. SFAS No. 143 requires companies to limit the asset retirement obligations recorded in depreciation expense to those asset retirement obligations that are required by law. For example, there are legal requirements that, at retirement, APS must dismantle certain plants and properly dispose of them. Thus, when APS calculates annual depreciation for these plants, it includes an amount in depreciation expense attributable to the cost of removal.

In the absence of a legal requirement to remove an asset, SFAS No. 143 prohibits companies from including the estimated future cost of removal in the annual depreciation expense for that asset. For example, expected costs to dispose of old computers or service trucks are not included in depreciation rates for those items. However, in the past, APS has included the estimated cost of removal of such assets in its depreciation rates. Thus, Staff recommended an unbundled, identifiable net salvage allowance that could be included as a component of depreciation expense and recorded in accumulated depreciation.

APS argued that SFAS 143 applies to financial accounting and not regulatory accounting. APS also argued that the Commission has long been aware that APS includes in depreciation expense the estimated future cost of removal of assets for which there is no legal retirement obligation and that such recovery has been included in APS' approved depreciation rates for many years. APS has not separately accounted for the cost of removal of such assets, so any current or future adjustment to depreciation expense based upon SFAS 143 would be the result of gross estimates.

Q. What other issue did Staff raise in its direct testimony regarding depreciation?

A. Staff also disagreed with the projected service lives adopted by APS for its current assets and for the assets proposed to be acquired from PWEC. Staff believed that APS chose to use service lives that were too short, resulting in higher depreciation rates, and, therefore, higher depreciation expense.

Q. How does the Settlement Agreement address the SFAS No. 143 issue and the service lives issue?

A. APS agreed to adopt Staff's recommended depreciation lives and to separately record and account for projected costs of removal and salvage within depreciation expense so that they can be identified in future rate cases. The Agreement provides that APS may continue to record all asset retirement obligations in depreciation expense in the manner reflected in their filing until further order of the Commission.

Q. What is the benefit of settling these issues?

A. The determination of the proper depreciation expense requires highly technical studies tempered with a great deal of judgment. Witnesses for commission staffs, consumer advocates and utilities can be equally compelling in their arguments for their respective positions. Yet, depreciation expense has a significant impact on revenue requirement. By coming to a reasonable compromise on depreciation issues, the resources of all the parties and the Commission may be devoted to other issues.

COST OF CAPITAL AND CAPITAL STRUCTURE

Q. What were the parties' original positions on the appropriate capital structure, cost of long-term debt and cost of equity capital?

A. The individual parties' recommended capital structures and costs of debt were very similar. There were great differences among the cost of equity recommendations. Staff recommended a capital structure of 54.8 percent long-term debt at a cost of 5.82 percent and 45.2 percent common equity at a cost of 9.0 percent. Staff's estimates of the cost of common equity range from 7.0 percent to 10.6 percent.

RUCO recommended a capital structure of 53.83 percent at a cost of 5.77 percent, 1.03 percent short-term debt at a cost of 3.0 percent, and common equity of 45.24 percent at a cost of 9.5 percent.

With the inclusion of the PWEC assets in rate base, APS requested a capital structure comprised of 54.95 percent of long-term debt at a cost of 5.76 percent and common equity of 45.05 percent at a cost of 11.5 percent.

Q. What does the Settlement Agreement propose for the capital structure and costs of debt and equity?

A. The Agreement adopted a capital structure of 55.0 percent long-term debt and 45 percent common equity and a cost of debt of 5.8 percent. The Agreement also proposes that the cost of common equity be set at 10.25 percent, which falls at the midpoint between Staff's and the Company's recommendations. It is also within the range of equity costs that Staff's testimony set forth as reasonable. Thus, Staff believes that 10.25 percent is a reasonable compromise.

DEMAND SIDE MANAGEMENT

Q. What were the various positions on Demand Side Management ("DSM")?

A. During the test year, APS incurred approximately $1.1 million in DSM costs. Staff's testimony recommended a $4.0 million per year cap on the level of APS' DSM expenditures. RUCO's testimony recommended increasing annual DSM expenditures by APS to $35.0 million. The Southwest Energy Efficiency Project ("SWEEP") also recommended large increases in funding in each year, beginning at $13.0 million in 2004, increasing to $41 million in 2006 and $50 million in 2014.

In its surrebuttal testimony, APS agreed that an expanded DSM program funded at an initial $3.0 million per year and capped at $10.0 million per year would be reasonable. For expenditures under that $10.0 million ceiling, APS would be permitted to collect net lost revenues, incremental staffing costs, and future funding requirements resulting from DSM workshops or subsequent proceedings.

Q. How did the Settlement Agreement resolve these huge differences?

A. Included in the base rate increase proposed by the Settlement Agreement is $10.0 million for expenditures on approved, eligible methods of DSM. An adjustor is also proposed that would recover a required, additional $6.0 million per year on DSM. This would result in $48.0 million of funding over the three years 2005 through 2007.

Q. Why is this a good compromise?

A. There was no disagreement among the parties that appropriate methods of DSM will ultimately benefit APS ratepayers by postponing or reducing the size of future generation and transmission. The Commission, itself, has expressed interest in implementing additional DSM programs. Thus, the main points of contention were the level of funding and the method of recovery. Although the funding level proposed in the agreement is much higher than current levels, the agreement also places restrictions on these expenditures to ensure that the funds will be devoted to the best economic use. For example, one of the conditions requires APS to submit all of its DSM programs to the Commission for pre-approval. In the past, APS' DSM programs were required to receive only Staff's approval. Also, to induce APS to expend money and effort to reduce demand for electricity, the Agreement includes a performance incentive equal to 10 percent of the total amount of DSM spending.

Thus, the proposed increase in the level of funding, along with other provisions designed to ensure that all DSM expenditures will be reasonable, met the satisfaction of all the parties.

ENVIRONMENTAL PORTFOLIO STANDARD AND OTHER RENEWABLES

Q. In their direct testimony, both Staff and other parties expressed the opinion that APS was not fulfilling the Commission's expectations regarding the use of renewable resources and compliance with the Environmental Portfolio Standard ("EPS"). What were some of the other positions the parties took in their direct testimony?

A. Western Resource Advocates, an organization described as working to protect and restore the natural environment of the interior American West, requested that the Commission remove the caps set in place by A.A.C. R14-2-1618. They also recommended that APS acquire at least 2 percent of its sales of electricity from renewable resources.

RUCO recommended that $6.0 million of the proposed EPS funding be "reassigned" to DSM, thereby placing lesser emphasis on renewables.

Q. How does the Settlement Agreement resolve these concerns?

A. Although the Settlement Agreement does not increase the existing level of expenditures for renewables ($6.0 million generated by base rates and $6.5 million generated through a surcharge in the Test Year) at least until the Commission completes the next EPS rulemaking, the Agreement calls for APS to issue an RFP in 2005 seeking at least 100 MW and 250,000 MWh per year of renewable energy resources. Through this RFP or other procurement, APS would seek to acquire at least 10 percent of its annual incremental peak capacity from renewables. If APS does not achieve this goal by the end of 2006, the Agreement requires APS to report the shortfall to the Commission and all parties to this docket.

Currently, the monthly cap on the EPS surcharge that APS could collect from residential customers is $0.35 and $13.00 from non-residential customers under 3 MW. For non-residential customers 3 MW and over, $39 per month could be collected. As will be discussed below, organizations representing large non-residential customers claim that their rates are subsidizing residential customers. The Settlement Agreement addresses this perceived imbalance; if the Commission increases the total amount of EPS funding before the next APS rate case, the proportion absorbed by non-residential customers will be identical to the proportion of total funding currently provided by non-residential customers.

Q. Why is this a good compromise?

A. The Agreement balances the desires of the parties in this case, for now, while leaving the ultimate level of EPS funding open to discussion and determination by the Commission in future proceedings, which are already underway.

TRANSMISSION COST ADJUSTOR

Q. What is the purpose of a Transmission Cost Adjustor?

A. A Transmission Cost Adjustor ("TCA") is designed to ensure that any potential direct access customers will pay the same for transmission as standard offer customers. If transmission costs change and APS receives approval by Federal Energy Regulatory Commission ("FERC") to change its Open Access Transmission Tariff ("OATT"), APS would be unable, until its next rate case, to pass the increase or decrease to its standard offer customers in the absence of a TCA.

Q. What were the positions of the parties in the direct case?

A. Staff supported the implementation of the TCA in its direct testimony because without a TCA, customers' choice between direct access service and standard offer service could be distorted. RUCO's testimony recommended that the TCA be denied and that the Commission retain "local control" over the transmission aspect of APS' operations.

Q. How does the proposed Settlement Agreement address the TCA issue?

A. The Agreement adopts a TCA but limits it to the recovery or refund of costs associated only with changes in APS' OATT. The Agreement also limits APS from filing for a change in the TCA until transmission costs increase more than 5 percent over test year levels.

Q. How is this an equitable solution?

A. The TCA would ensure that APS' current customers will not be impeded from becoming Direct Access customers or become motivated to become Direct Access customers due to differences in transmission rates.

BARK BEETLE REMEDIATION

Q. What is a bark beetle and why is it addressed in the Settlement Agreement?

A. Bark beetles are small brown beetles about the size of a match head that bore into pinion and ponderosa pine that have been weakened by disease or drought. According to the USDA Forest Service, the current bark beetle infestation has killed tens of millions of pine trees in Arizona. In its rebuttal testimony, APS has requested approximately $8.0 million per year, for five years, for use in clearing dead and dying trees around transmission and distribution lines.

The Settlement Agreement proposes to allow APS to defer, for possible future recovery, the reasonable and prudent direct costs of bark beetle remediation that exceed test year levels of tree and brush control. The deferral account shall not accrue interest and will be subject to Commission review in APS' next rate case. The parties believe this is a preferred and more precise method of recovery than asking the Commission to pre-approve an estimated level of costs.

NUCLEAR DECOMMISSIONING FUND

Q. What were the parties' positions on nuclear decommissioning?

A. Staff was the only party to examine and provide testimony regarding APS' nuclear decommissioning study and requested level of funding. Staff's direct testimony determined that APS' most recent nuclear decommissioning study (completed in 2001) for the most part used reasonable assumptions and conformed to the methodology employed in the industry. However, Staff proposed that APS' Palo Verde Unit 2 decommissioning funding schedule be adjusted to match the licensed life of the unit. Staff also testified that APS had not taken into account possible uses of the decommissioned Palo Verde site and the value of such use.

APS argued that there is no reason to change the funding levels which are under the oversight of the NRC and GAO and have been determined in the past to be adequately funded. APS also argued that the current funding levels have been approved by all of the other Palo Verde participants and that changing them would be difficult procedurally.

The Settlement Agreement proposes to adopt APS' recommended level of decommissioning costs. Staff accepted APS' arguments to a degree, but primarily agreed to the current level of funding based upon the possible negative consequences of underfunding.

COST OF SERVICE AND RATE DESIGN

Q. Which parties were interested in APS' cost of service study ("COSS") and rate design proposals and what were some of their positions?

A. The positions of the parties on these issues are especially disparate. Except for the method of allocation of generation capacity set forth by APS, Staff supported APS' choice of allocators. Staff also provided testimony that, although cost is an important factor in spreading revenue requirement among customer classes and rates, it is not the only factor that should be considered.

RUCO's testimony indicated that APS' cost of service study overstates the cost of serving residential customers and that APS' revenue spread does not conform to good ratemaking principles.

Kroger Company presented issues related to APS' proposed voltage levels in the design of E-32 rates but did not oppose the methodology APS used in its COSS.

The Federal Executive Agencies ("FEA") recommended approval of APS' COSS methodology, but rejected APS revenue spread. FEA asked the Commission to move rates closer to cost, to reduce APS' proposed transmission voltage discount and to increase the primary voltage discount.

Q. How were these issues resolved?

A. The Settlement Agreement does not adopt a particular cost of service study methodology. The rate design section of the Settlement Agreement is comprehensive. In brief, the rates agreed upon are the result of a movement toward cost. The residential rate class, as a whole, would experience a 3.94 percent increase. Within the residential class, E-12, ET-1 and ECT-1R rates (time-of-use rates) will increase by 3.8 percent. Frozen residential rate schedules EC-1 and E-10 would receive a 4.82 percent base rate increase. Most General Service rates and contracts contained in the General Service section of the H schedules will each experience an increase of 3.5 percent.

APS would also establish a Primary Service Discount exclusively for military base customers who are served directly from APS substations. This action reflects the importance to the Arizona economy in general, and specifically to APS' system, of retaining the federal agencies locations in Arizona.

Q. What other rate design related benefits are reflected in the Settlement Agreement?

A. Among several benefits, APS has agreed to submit a study that examines ways in which APS can implement more flexibility in changing its off and on-peak periods to better reflect its peak. The results of such a study can be very important to time of use customers and could ultimately result in lowering peak demand.

Certain rate schedules were streamlined and others clarified, making them more easily understood by the customers and better enabling customers to choose the best rate for their usage patterns. Finally, the rate schedules contained in the Settlement Agreement enhance the opportunity for retail access through the unbundling of standard offer rates and the pricing of certain competitive service rate elements to reflect cost. This provides customers with the price signals they need to make informed decisions about shopping for competitive services.

Q. Are the rates that resulted from the negotiations fair?

A. Staff believes that the rates resulting from the Settlement Agreement will generate the agreed-upon revenue requirement in a fair and reasonable manner and fairly reflect the interests of the parties.

LITIGATION AND OTHER ISSUES

Q. Please describe the litigation-related issues that would be resolved by the Settlement Agreement and explain why their resolution is in the public interest?

A. APS appealed the Track A order in both Superior Court and the Court of Appeals. Affiliates of APS also initiated another lawsuit, which includes breach of contract claims allegedly related to the Track A order, in Superior Court. APS contends in these various appeals that it should be compensated for monetary damages allegedly caused by the Commission. All of these actions are inactive at the present time, and the parties await the outcome of this proceeding.

Any lawsuit creates risk, and Staff recognizes that if APS were to succeed in these claims, ratepayers and/or taxpayers may have to bear significant costs. The Settlement Agreement proposes to resolve these matters. Specifically, APS has agreed to drop its appeals of the Track A order and Decision No. 61973 and to forever forego any claim that APS, PWEC, Pinnacle West Capital Corporation or any of its affiliates were harmed by these decisions. APS has also agreed not to seek recovery of the $234 million write-off recorded at the time of the 1999 settlement agreement in any future proceeding. Thus the determination of alleged harm related to these decisions and related monetary impacts will not be raised by APS in future cases.

The withdrawal of these court cases would relieve the ratepayers of any risk related to a possible negative outcome. The issue of $234 million (and possibly more) that APS believes the ratepayers owe them would disappear with the dismissal of these cases. The resolution of these cases, along with resolution of the Preliminary Inquiry ordered in Commission Decision No. 65796, would essentially "clear the decks" of risky, protracted, complicated proceedings that if not resolved would likely continue generating high costs for all affected parties in terms of time, effort and personnel.

Q. Does this conclude your direct testimony?

A. Yes, it does.