BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER
Chairman
WILLIAM A. MUNDELL
Commissioner
JEFF HATCH-MILLER
Commissioner
MIKE GLEASON
Commissioner
KRISTIN K. MAYES
Commissioner

IN THE MATTER OF THE APPLICATION OF	)	DOCKET NO. E-01345A-03-0437
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	)	
THERON, TO APPROVE RATE SCHEDULES	)	
DESIGNED TO DEVELOP SUCH RETURN, AND	)	
FOR APPROVAL OF PURCHASED POWER	)	
CONTRACT	)	

DIRECT

TESTIMONY

OF

LINDA A. JARESS

EXECUTIVE CONSULTANT III

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

FEBRUARY 3, 2004

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EXECUTIVE SUMMARY
ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. E-01345A-03-0437

Staff recommends a **decrease** in APS' revenue requirement of $142.7 million or 8.0 percent compared to APS' request for an increase of $175.1 million or 9.8 percent. The single largest disputed issue in this case is the treatment of the Pinnacle West Energy Corporation ("PWEC") assets which have a revenue impact exceeding $100.0 million per year. Staff is recommending against ratebasing the PWEC assets in large part because APS has not demonstrated that these assets represent the best economic choice for its customers. Further, inclusion of the PWEC assets in rate base may negate over $200.0 million in expected savings (over a three-year period) associated with the Commission's competitive bidding process carried out under Track B.

Staff's recommended decrease was derived using an original cost rate base of $3.1 billion, a rate of return on original cost rate base of 7.26 percent and a cost of equity of 9.0 percent. APS' request for an increase was derived from a rate base of $4.21 billion, an 8.67 percent rate of return and an 11.5 percent cost of equity. Staff's lower recommended rate of return better recognizes interest rates that have declined significantly in the past twenty years to levels comparable to the 1950 and '60's.

Staff also recommends that APS should not recover the $234.0 million that APS wrote-off as a result of the order approving the 1999 Settlement Agreement and now proposes to recover over a fifteen year period. Staff's testimony shows that recovery of the $234.0 million does not meet standard rate-making criteria and that the going-forward revenue requirements have not been reduced by the write-off.

Staff is opposed to a fuel or purchased power adjustor that does not prevent unintended benefits to APS' shareholders and harm to customers under high load growth conditions.

Regarding the preliminary inquiry ordered by the Commission in Decision No. 65796 and moved to this case, Staff believes that APS' actions during the transition to competition violated the spirit, if not the letter, of the Retail Electric Competition Rules, the Code of Conduct and the order approving the 1999 Settlement Agreement. Also, the public statements made by APS, PWEC and Pinnacle West Capital Corporation representatives are conflicting regarding the purpose for which certain PWEC generating plants were built.

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. Please state your educational background and professional experience.

A. I received a Bachelor of Arts Degree from Michigan State University and a Master of Business Administration Degree from the University of Hawaii. I was employed as a Research Analyst for the Hawaii Trucking Association from 1977 through 1978 and as a Financial Analyst for the State of Hawaii, Division of Consumer Advocacy from 1980 through 1985. In 1985, I was employed by the Arizona Corporation Commission ("Commission") as a Senior Rate Analyst and received a promotion to Manager, Financial Analysis in 1991. I also served as the Acting Chief of the Accounting and Rates Section for a total of 12 months during 1997 and 2000. On January 1, 2001, I was promoted to the position of Executive Consultant III.

Q. Please list your duties and responsibilities as Executive Consultant III.

A. I complete special projects for the Director and Assistant Directors. Among those projects are report writing and oversight of the RFP process for most of the RFPs issued by the Utilities Division. I also write testimony and Staff Reports and serve as the Director's Office liaison with consultants.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to summarize Staff's testimony and recommendations regarding Arizona Public Service Company's ("APS") request for an increase in rates. I

will address some of the broader assertions of APS witnesses that ratepayers are obligated to reimburse APS for a $234 million write-off it made as a result of the order approving the 1999 Settlement Agreement and that the Commission is obligated to rate base the generation assets of Pinnacle West Energy Corporation ("PWEC"). I will also address APS' request for Commission approval of the APS/PWEC power contract. Finally, my testimony will provide the results of the preliminary inquiry ordered by Decision No. 65796.

SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Q. Please discuss the most significant issues in the rate case and summarize Staff's position or recommendation on each issue.

A. APS proposed a $175.1 million, or 9.8 percent increase in revenues. Staff recommends a $142.7 million, or 8.0 percent **decrease** in APS revenues. The single largest disputed issue in this case is the treatment of the assets of APS' affiliate, Pinnacle West Energy Corporation ("PWEC"). Exclusion of these assets from APS' rate base reduces APS' annual revenue requirement by over $100.0 million.

Staff is recommending against ratebasing the PWEC assets in large part because APS has not demonstrated that these assets represent the best economic choice for its customers. Further, inclusion of the PWEC assets in rate base may negate over $200.0 million in expected savings (over a three-year period) associated with the Commission's competitive bidding process carried out under Track B.

APS' requested increase was derived from an original cost rate base of $4.21 billion, an 8.67 percent rate of return and an 11.5 percent cost of equity capital. Staff's decrease was derived from an original cost rate base of $3.1 billion, a rate of return on original cost rate

base of 7.26 percent and a cost of equity of 9.0 percent. Staff's lower cost of capital better recognizes interest rates that have declined significantly in the past twenty years to levels comparable to the 1950 and '60's.

APS also requested the recovery of $234 million ($183 million after tax) that it wrote off after the 1999 Settlement Agreement. Staff testimony shows that recovery of the $234 million does not meet standard rate-making criteria that rates should reflect test-year or ongoing costs and that the going-forward revenue requirements have not been reduced by the previous write-off. Staff does not believe that the $234 million represents stranded costs, but if interpreted as stranded costs, the amount should not be collected because the Company will have collected its stranded costs through other provisions of the order approving the 1999 Settlement Agreement.

APS requested an increase in fuel and purchased power expenses of $121 million over those recorded during the 2002 test year. Most of the increase is attributable to the increased costs of gas. Staff is recommending that rates include an increase of $114.6 million for fuel and purchased power.

Staff's review of APS' cost estimate for decommissioning the units at the Palo Verde Nuclear Generating Station ("Palo Verde"), concludes that, for the most part, APS' cost estimates conform to the methodology employed in the industry and are consistent with the minimum requirements of the Nuclear Regulatory Commission. However, Staff reduced the annual contribution of APS customers for decommissioning to reflect a higher residual value of some of the structures, systems and infrastructure of Palo Verde. Also, Staff adjusted the Unit 2 decommissioning funding schedule so it matches the licensed life of the unit.

Staff opposes a fuel and/or purchased power adjustor unless APS is able to resolve a critical imbalance that would occur under certain conditions. An imbalance to the detriment of customers would occur between the recovery of fixed production costs through base rates and the recovery of fuel and purchased power expenses through the adjustor mechanism during periods of high load growth.

Staff recommends spreading the rate decrease over all customer classes, although at different percentages. A cost of service study was used by Staff as a guide to determine those percentages, but the overriding factor in our rate design guidelines was ensuring that all customers benefited from the rate decrease.

Staff recommends that APS recover its costs for pre-approved demand-side management (DSM) programs through a DSM adjustment mechanism. Staff recommends that the caps per service on the EPS-1 surcharge tariff be increased to help APS meet its Environmental Portfolio Standard requirements. This will result in an increase in spending for renewables of $4.4 million. Staff does not oppose APS' requested Returning Customer Direct Assignment Charge with conditions. Finally, Staff recommends some changes to the selected charges and wording on APS' proposed service schedules.

Q. Provide the names of Staff's witnesses and the subject matter of their testimony.

A. The chart shown below lists each Staff witness and the subject matter of their testimony.

Witness	Consultant or Utilities Division Staff	Topical Areas
Linda Jaress	Staff	Summary of Staff's Case, Response to Certain APS Assertions and Results of Preliminary Inquiry
Barbara Keene	Staff	System Benefits, Env. Port. Std. DSM, RCDAC and Service Schedules
Joel Reiker	Staff	Capital Structure, Cost of Debt, Return on Equity and Overall Cost of Capital
Erinn Andreasen	Staff	Rate Design
Lee Smith	LaCapra Associates	Cost Allocation, Competition Rules Compliance Charge Treatment of Transmission Costs and Adjustor, $234 M Write-Off.
Harvey Salgo	LaCapra Associates	Regulatory Treatment of PWEC Assets and Track B Purchased Power Contracts
Doug Smith	LaCapra Associates	Purchased Power and Fuel Costs and Off-system Sales.
Michael J. Majoros,	Snavely King Majoros O'Connor & Lee	Depreciation
Steven Carver	Utilitech, Inc.	Rate Base and Income Statement Adjustments – Cash Working Capital, Severance Costs
James Dittmer	Utilitech, Inc.	Rate Base and Income Statement Adjustments – Property Taxes, Econ. Development/ Advertising
Harold Judd	Accion Group	Nuclear Decommissioning Planning and Funding

Q. Provide a brief reconciliation of APS' revenue requirement request with Staff's recommendations.

A. Below is a chart that reconciles the major differences between APS' and Staff's revenue requirement recommendations. The chart begins with APS' requested increase, then

illustrates the most significant individual reductions recommended by Staff and ends with the resulting Staff recommendation for a decrease in revenue requirements.

APS' Recommended Overall Rate Increase ($000)	**$175,090**
Less:	
Rate Base and Operating Income Impacts of Removal of PWEC Assets from Rate Base	(105,539)
Difference in Cost of Capital	(74,644)
Difference in Proposed Depreciation Rates (other than PWEC Assets)	(40,703)
APS' Proposal to Reverse 1999 Settlement Write Down -- Rate Base & Expense Amortization	(29,674)
APS' Proposed Inclusion of Non-Cash Expenses in Lead Lag Study & Other Corrections	(10,291)
Difference in Property Tax Expense	(9,196)
Disallowance of Discretionary Economic Development, Advertising & Charitable Contributions Expense	(6,872)
Eliminate APS' Proposed Amortization of Severance Costs	(6,189)
Difference in Fuel & Purchased Power Costs with PWEC Excluded from Rate Base	(6,020)
Difference in Recommendations for Nuclear Decommissioning Provision	(5,697)
Difference in Methods of Jurisdictional Allocations	(5,076)
All Other Miscellaneous Rate Base & Operating Expense, and CRCC Differences	(22,279)
Environmental Portfolio Standard Revenues	4,400
Staff's Proposed Overall Rate (Decrease)	**($142,690)**

REBUTTAL OF MR. WHEELER AND DR. HIERONYMUS

Q. Please address the "equitable considerations" that Mr. Wheeler's direct testimony requests the Commission address in its Decision.

A. Mr. Wheeler requested that the Commission rate base certain of the PWEC assets as reparation or "equitable consideration" for halting divestiture of APS' generating plants. He testified that "APS and its affiliates made concessions of considerable value and have relied in good faith to their ultimate detriment on the restructuring requirements of the

Electric Competition Rules and the promises of the 1999 Settlement." Also, Mr. Wheeler testified that "Along with reversal of the 1999 Settlement $234 million write-off, rate basing the PWEC assets will significantly mitigate the unaddressed impacts resulting from that Order."

Staff disagrees with Mr. Wheeler's assumption that the Commission must rate base the PWEC assets and allow APS to reverse the $234 million write-off in order to appropriately address the impacts of the Track A order. First, Staff Witness Lee Smith discusses in detail why it is not necessary for the Commission to allow APS to reverse the $234.0 million write-off related to the 1999 Settlement Agreement and how APS has not shown that the write-off was detrimental.

Second, the Commission has taken extraordinary actions to prevent "detriments" to the financial health of APS and its affiliates from the change in the course of divestiture. Decision No. 65434, dated December 3, 2002 approved APS' emergency request for a waiver of the Affiliated Interests Rules to loan PWCC $125.0 million when PWCC lost its ability to renew a bank facility. The speed with which the Commission responded is a further indication of the Commission's willingness to address the impacts of the Track A order. The application was filed on November 8th and the Decision was issued less than one month later.

Decision No. 65796, issued April 4, 2003, approved a $500.0 million loan or guarantee from APS to PWEC. The Decision recognized that, with conditions, the financing was in the public interest even though acknowledging on page 39 that "the transaction poses some risks to the Company and to its ratepayers…"

Finally, within this case, Staff is making two recommendations that, if adopted, will also help ensure that APS and its affiliates do not suffer "detriments". First, as will be discussed below, Staff is recommending the Commission approve the costs related to the APS/PWEC purchased power contract entered as a result of the Track B solicitation. Ordinarily, utilities do not request, Staff does not recommend, nor does the Commission approve, future purchased power contract costs. Second, Staff is recommending approval of the Competition Rules Compliance Charge ("CRCC") that recovers the reasonable costs incurred by APS during its compliance with the Retail Competition Rules. Staff's recommendation includes the extra thirty-three percent of the costs of divestiture that, according to the Addendum to the 1999 Settlement Agreement, APS' shareholders were to bear. Thus, both Staff and the Commission have taken actions to address the impacts of the Track A order.

Q. Please address Dr. Hieronymus' assertions in his testimony that the Commission should determine the prudence of the Redhawk, West Phoenix and Saguaro generation units when constructed by PWEC and that it is <u>not</u> appropriate to analyze the contemporary economics of the PWEC generation when determining their rate base treatment.

A. Staff strongly disagrees with Dr. Hieronymus' testimony on this issue. The prudence of the construction and cost of construction of assets owned by a non-utility enterprise (PWEC) is irrelevant to the determination of APS' rate base. Certainly, the potential transfer price along with APS' need for assets from a non-utility would be of interest to the Commission. However, if APS were purchasing assets from another, non-affiliated generating company and requested rate base treatment of those assets, the prudence, or for that matter the purpose, of the assets when originally built would have no relevance to the Commission's decision to rate-base or not rate-base the assets.

Finally, it would be neither logical nor fair to APS' ratepayers for the Commission to allow rate base treatment of assets constructed by a non-utility based on circumstances when the assets were built and ignore whether or not they are prudent additions to APS' generation portfolio today.

REQUESTED APPROVAL OF THE APS/PWEC CONTRACT

Q. Mr. Wheeler also requested that the Commission approve and "assure cost recovery" of the recently executed Track B power contract between APS and PWEC. Why does APS believe Commission approval is necessary?

A. Section 3.4 of the APS Master Power Purchase and Sale Agreement that applies to the APS/PWEC contract includes the following language:

> "APS will file with the ACC an application for approval and full cost recovery by APS for such Transactions within sixty (60) days after acceptance of the Transaction ("the Request for Approval"). If the ACC has not issued a final order expressly approving full recovery of all costs incurred by APS in such Transactions within twelve (12) months of the submission of the Request for Approval either party may, at its option, terminate the Transaction as to any and all deliveries on or after January 1, 2006 without further liability."

Also, Mr. Wheeler's testimony stated that "APS cannot afford to jeopardize its rights under the contract" and that APS is making the filing in this case, "to protect its rights under the PWEC contract, which is critical to meeting the needs of APS customers…" These statements imply that if the Commission does not approve the APS/PWEC contract, PWEC or APS might exert their rights to terminate the contract after January 1, 2006 leaving APS open to the market for a large amount of power.

Q. What is Staff's recommendation regarding the approval of the APS/PWEC contract?

A. The Commission generally has not approved the purchased power contracts of investor-owned utilities. The Commission determines the reasonableness of the expenses incurred under purchased power contracts after the contracts are in effect. However, Staff believes that the APS/PWEC power contract is extraordinarily favorable to customers. Thus, Staff recommends that the Commission take the highly unusual step of approving the costs incurred under the APS/PWEC contract as requested.

Q. Should the Commission continue to pre-approve the costs incurred under APS' purchased power contracts?

A. It is the utility's responsibility to enter prudent contracts whether for power, fuel or office supplies, and the risk of recovery of the costs incurred under those contracts should remain with the utility. If not for the special circumstances of this case, Staff would recommend that the Commission dismiss the application for pre-approval of "full recovery of all costs" incurred in this purchased power contract. In fact, the Commission should put APS on notice that it is APS' responsibility to write and manage its power contracts in a prudent manner. If APS writes a clause into a contract that relies upon an action of the Commission, the risk that the Commission may not take that action should be born by APS.

PRELIMINARY INQUIRY INTRODUCTION

Q. How is your testimony on the preliminary inquiry organized?

A. First, I will provide the background of the Commission's Decision to direct Staff to conduct a preliminary inquiry. Then, I will address specific concerns about Arizona Public Service Company's ("APS") actions listed in that Commission's decision.

Q. What conclusions have you drawn from the inquiry?

A. I conclude that APS' actions during the transition to competition violated the spirit, if not the letter of the Retail Electric Competition Rules ("the Rules"), the Code of Conduct and the order approving the 1999 Settlement Agreement ("Settlement Agreement".) APS took actions that increased its natural competitive advantage to the detriment of others who intended to participate in electric competition. Although these actions should also be judged independent of their consequences, ratepayers appear to have been unharmed by the actions at issue.

ORIGIN OF THE INQUIRY

Q. Provide the background of this preliminary inquiry.

A. The preliminary inquiry was ordered by the Commission on April 4, 2003, in Decision No. 65796 which approved, with conditions, the application of APS to issue up to $500.0 million of debt and loan the proceeds to PWEC ("the Financing case"). The purpose of the debt was to enable PWEC to refinance shorter-term bridge loans incurred for the construction of generation assets in Arizona and Nevada.

Q. Provide the portions of Decision No. 65796 that supported and required the preliminary inquiry.

A. In Note 18, on pages 33 and 34, the Decision said:

> "During that two-year period [January 1, 2001 to January 1, 2003,] APS' parent formed competitive affiliates, including PWEC, and PWCC/PWEC built 4 new generating units and obtained a contingent investment grade rating for PWEC…APS' position in this application that these assets were "dedicated" to APS customers raises the issue of possible intended noncompliance with the Commission's electric competition rules and/or possible anti-competitive activity."

On Page 34, lines 16 through 21, the Decision said,

> "Further, we believe that a preliminary inquiry into APS, PWCC, and PWEC's actions related to the transition to electric competition, particularly compliance with our electric competition rules and with Decision No. 61973 and APS' activities with its affiliates should be undertaken by Staff. Of concern to us is testimony and evidence elicited during this hearing of the PWCC enterprise's possible use of APS (both its generation assets and captive ratepayers) to gain advantage in the developing competitive environment."

And, on Page 44:

> "That Staff shall commence a preliminary inquiry into Arizona Public Service Company and its affiliate's compliance with the Electric Competition Rules, Decision No 61973, its Code of Conduct, and applicable law."

Q. How was the inquiry conducted?

A. I reviewed the record in the financing case that resulted in Decision No. 65796, ("the Financing Decision"), including the testimony, hearing transcripts, and Open Meeting transcripts. Data requests and responses from the financing case were reviewed and additional data requests were sent. I also reviewed relevant data responses in this rate case. The Rules, the APS Code of Conduct, Decision No. 61973, the Settlement Agreement, APS and PWCC 10Ks and 10Qs filed with the Securities Exchange Commission and annual reports were also reviewed. I also reviewed recordings of the 2000 presentation to rating agencies made by PWCC and APS officers.

Q. Please summarize the five issues raised by the Decision that you are going to address in your testimony.

A. A significant portion of the Financing Decision was devoted to concerns over how PWEC was able to obtain an investment grade rating from bond rating agencies in early 2001

when it was seeking to acquire long-term financing to construct generating plants. The Decision discussed possible contractual relationships among APS, PWEC and parent, Pinnacle West Capital Corporation ("PWCC") that resulted in an APS commitment to purchase either directly or indirectly, the full output of the PWEC plants for four years ending December 31, 2004. The four-year period would have extended into the time when APS was required to be purchasing its power directly from the market through competitive bids and arms-length transactions. The issue of whether the presentation of the contracts to the bond rating agencies gave the PWCC entities an unfair competitive advantage will be addressed as Issue #1.

Issue #2 raised by the Decision is the existence of a contract between APS and an affiliate that may have been anti-competitive. PWEC's construction of generating plants with the explicit intention of serving APS is Issue #3.

Another concern expressed in the Decision, Issue #4, is related to APS' assertion that it could not build plants during the period between the approval of the Settlement Agreement and divestiture. Issue #5 is the fairness of APS' application for an air quality permit on behalf of PWEC. Finally, Issue #6 addresses the transfer of land from APS to PWEC for the purposes of the construction of the generating plants by PWEC.

ISSUE #1 – PWEC'S REPRESENTATIONS TO THE BOND RATING AGENCIES

Q. What information was provided to the bond rating agencies in early 2001 that may have increased the bond rating of PWEC and given it an unfair advantage in the nascent Arizona retail electric competition market?

A. At least one of the bond rating agencies was provided with draft contracts that, if consummated, would have resulted in APS' purchase, directly or indirectly, of all of the output of PWEC until December 31, 2004.

Q. Why are contracts for the output of generating plants important to bond rating agencies?

A. Bond ratings generally reflect the level of risk in an investment. An investment in a merchant generating plant that is either planned or under construction is safer if a contract has been entered for the sale of all of the plant's output compared to an investment in a plant with no assured purchaser of its output. A safer investment receives a higher bond rating. Bonds with higher ratings have lower interest rates. All else held constant, the ultimate cost of the power from a merchant plant with a higher bond rating will be lower than the cost of power from a plant with a lower bond rating.

Q. Why would it have been unfair for PWEC to represent to the bond rating agencies that it had a firm purchaser for all of its power for four years?

A. It would have been unfair because it would indicate to the rating agencies that few or none of the other merchant plants would be selling much or any power to APS, the largest electric utility in Arizona. This would put the other plants at a disadvantage in obtaining a favorable bond rating, attracting financing or generating revenue because their potential market would shrink considerably.

Q. How do you know that the bond rating agencies were supplied with draft contracts?

A. One of APS' supplemental responses to Panda data request 1.42 in the Financing case, shows that the bond rating agencies were supplied with the draft contracts.

Q. During the hearing in the Financing case, what did APS say was the purpose of the contracts?

A. Ms. Barbara Gomez (Treasurer of APS, PWCC, PWEC, and APS Energy Services) testified that the contracts were used as modeling assumptions and "stress tests" during PWEC's negotiations with the bond rating agencies. One line of questions from both Panda and the Administrative Law Judge to Ms. Gomez was related to the aforementioned contracts. Here is one exchange between Ms. Gomez and Mr. Engleman who represented Panda:

> Q. Isn't it correct that APS – or excuse me – that Pinnacle West Energy Corp. told the credit rating agencies that they had a contract to sell all of their output and that it would continue for four years?
> A. Basically, what it is is that we made the assumption that there would be a purchased power agreement occurring…So the assumption was made that for the first two years, '01 and '02, that there would be 100 percent of PWEC's assets would be sold back to APS. And from '03 on, it was assumed that it would go through the competitive bid process. But it was assumed that there would be the four years of a PPA. And then that PWEC, the way the rating agencies like to look at it, is they assume that it's 100 percent merchant thereafter because we had no signed contracts to be able to show them.
> Q. When you say 100 percent merchant thereafter, after 2004 or after January 1, 2002?
> A. After 2004. (January 8, 2003 Transcripts pages 143 and 144)

Q. Did the bond rating agencies realize that the contracts supplied to them were draft contracts?

A. Apparently Standard and Poor's believed they were valid contracts. In Exhibit Panda-5 placed in evidence in the Financing hearing, Standard and Poor's supported its April 18,

2001 triple "B" corporate credit rating of PWEC as reflecting "A four year purchased power agreement (PPA) with APS that provides a secure off-taker for 100% of PWEC's capacity through 2002, though less than 50% for 2003 and 2004."

In another APS response to Staff 11-64, APS provided an article by Moody's Investors Service dated April 18, 2001 that said, "Although APS will be moving its generating assets into PWEC, Moody's expects the relationship between PWEC, PWCC and APS to function as a vertically integrated utility servicing the needs of Phoenix, especially during the next four years." And Moody's also commented that "The signing of the all-requirements contracts coupled with PWEC's plans to add significant electric capacity in Arizona demonstrate a commitment to that strategy." Thus, whatever information APS had given to Moody's, the analyst writing the article clearly believed the contracts were signed and resulted in relationships among the PWCC affiliates that would result in operations substantially the same as before divestiture.

Q. Have the bond rating agencies indicated the extent to which their bond ratings for PWEC were influenced by the existence of the draft contracts?

A. No, they have not. Staff sent APS data requests (LAJ 5.41) asking APS to ask the bond rating agencies to supply that information. APS responded that it had directed the questions to the appropriate individuals at Standard and Poors and Fitch. As of the date of the filing of this testimony, Staff has not received any further responses.

ISSUE #2 – APS' DIRECT OR INDIRECT CONTRACT WITH ITS GENERATION AFFILIATE

Q. How did the Rules limit APS' purchases from PWCC and PWEC?

A. A.A.C. R14-2-1615 (A) required divestiture of APS' competitive assets including generation by January 1, 2001. This date was extended to January 1, 2003, by the Settlement Agreement. The language in the Rules limiting APS' power purchases after January 1, 2003, reads as follows:

> A.A.C. R14-2-1606.B. After January 1, 2001, *[January 1, 2003 for APS]* power purchased by an investor owned Utility Distribution Company for Standard Offer Service shall be acquired from the competitive market through prudent, arm's length transactions, and with at least 50% through a competitive bid process."

Thus, APS would need to have divested its generation, become a distribution company and be purchasing all of its power to sell to Standard Offer Customers from the market by the same date of January 1, 2003.

Q. Did the Settlement Agreement allow APS to purchase power from PWEC, the affiliate to which APS was transferring its generation assets?

A. Yes, it did. The Addendum to the Settlement Agreement filed in compliance with the Decision approving the Settlement Agreement provided that:

> "An affiliated generation company formed pursuant to this Section 4.1 may competitively bid for APS' Standard Offer load, but enjoys no automatic privilege outside of the market bid on account of its affiliation with APS."

Q. Was there any prohibition against PWCC selling power to APS?

A. No. But such sales, according to the Rules, would have to be either through competitive bid or through an arm's length transaction.

Q. From the two excerpts from the Rules and the Addendum shown above, what do you believe the Commission intended?

A. The Commission expected a competitive bid process where (if it desired to sell power to APS) PWEC, the "affiliated generation company" would bid to supply APS power for its Standard Offer Customers on an equal basis with other generating companies and that APS would enter power contracts in arms-length transactions.

Q. Please describe the contracts supplied in response to Panda data request 1.42.

A. One contract was a Power Sale Agreement between PWEC and PWCC, by and through its marketing and trading division and pursuant to PWEC's market rate tariff and service agreement. Under this contract, PWEC would sell all of its output to PWCC. The other contract was between PWCC and APS whereby PWCC would supply all of APS' power.

These contracts appear to be fully developed, detailed purchased power agreements containing the term of the contract (beginning when the APS generation fossil assets transferred to PWEC through December 31, 2004), the date of the contract (January 1, 2001), and exhibits. In the contract between PWEC and PWCC, the exact amounts of fixed payments to be made by PWCC are delineated in an appendix, shown separately for each month for certain identified units. Formulae are given to determine after-the-fact adjustments for actual vs. projected gas burns and for variable payments for certain units. Names and titles are printed under the signature blocks, but the copies provided were not signed. The agreement between PWCC and APS is similarly written, but not identical.

According to a response to Staff data request LAJ 6.4, the primary author/drafter of both of the contracts was an attorney with Pinnacle West Capital Corporation.

Q. What is the significance of the December 31, 2004 ending date of the contracts?

A. December 31, 2004 is two years after the date when APS was required to be purchasing power "from the competitive market through prudent, arm's length transactions, and with at least 50 percent through a competitive bid process."

Q. In conducting this inquiry, have you become aware of any competitive bid process that APS conducted that resulted in the draft contract with PWCC?

A. No, I am not.

Q. Do you believe the draft contracts were negotiated as arms length transactions?

A. No, I do not.

First, in response to LCA 3-68, APS revealed that from 1997 until the Track A Order, resource planning and generation were part of the same business unit and that this unit was "to encompass both APS generation for as long as that generation remained at APS, and any new generation affiliate required by the ACC." This implies that at least until the Track A order in September, 2002, APS and PWEC planning and generation activities were joint.

Second, according to APS witness Dr. Hieronymus, on page five of his direct testimony, "planning functions sometimes were wholly in APS and sometimes were split between APS, PWEC and Pinnacle West corporate." This statement indicates that there were no clear lines of demarcation regarding which entity was planning for which entity. Under

such relationships, arms-length transactions among the affiliates would be difficult, if not impossible.

Finally, APS itself acknowledges in its response to STF11-66 that it may be impossible for affiliates to enter arms-length transactions between and among themselves. When asked to explain how the draft contracts fulfilled the arms-length transaction requirement of Rule 1606 (B), APS replied that "…with those caveats [Rule 1606(B) wasn't in effect yet] APS has interpreted the term 'arms-length' in terms of *result* rather than in terms of *process*. (emphasis added) This is necessarily so since affiliates cannot, as a practical matter, negotiate as if they were not affiliates."

Q. How did APS reach the conclusion that it did not need to purchase power through arms-length transactions or competitive bid as required by the Rule and the order approving the 1999 Settlement Agreement?

A. In response to data request LAJ-6.27, a question about the potential impact of the APS/PWCC and the PWEC/PWCC draft contracts, APS indicated that it believed the Rule did not forbid bi-lateral contracts. The relevant portion of APS' response is as follows:

> "Also, at the time the PPA arrangements were developed, there was no guidance from the Commission as to how either the 50% 'competitive bid' provision of Rule 1606(B) would work in practice even after it became effective in 2003…Likewise, the portion of APS needs post-2002 that Rule 1606(B) clearly allowed to be obtained through bilateral contracts of the type contemplated in the then-anticipated PPA was only limited by the need for it to come from 'the wholesale market' and be 'arms length.' The 'wholesale market' was precisely where PWCC was to obtain power for APS needs (PWEC is as much a part of the 'wholesale market' as any non-affiliated generator), and there was no reason for APS or PWCC to believe that the Commission would conclude that a market-based PPA for the remaining 50 percent of APS' requirements, (even if supplied, at least in part, from the assets that APS was required to divest), would not comply with that requirement of Rule

> 1606(B), or that the Commission would reject an alternative cost-based arrangement when later proposed for its approval."

Q. If the contracts between APS and PWCC and PWCC and PWEC had been consummated, what could have been the effects on APS' Standard Offer Customers?

A. In the short run, there would have been no effect. Pursuant to the Settlement Agreement, APS' rates decreased every July 1st through 2003 regardless of the cost of power to APS. Even if PWCC was selling PWEC's power directly to APS at higher than market prices, APS would have had to absorb that cost and would not have had the opportunity to pass on the costs to ratepayers until July 2004 when its purchased power mechanism was scheduled to go into effect. In the long run, (in the absence of the Track A and B Decisions) if the contracts diminished competition and, in the extreme, drove PWEC's competition out of business, APS' Standard Offer Customers could have paid "monopoly prices" under retail competition.

Q. Continuing this scenario, couldn't APS' Standard Offer Customers have become direct access customers of other electric service providers if APS prices became high?

A. Yes. However, if the contract arrangement allowed PWEC to sell all of its power to APS for four years, it likely would have reduced the incentive for potential competitors to build plants to serve Arizona and customers ability to choose an alternative generation provider could have been severely limited or even non-existent.

Q. Is the draft contract between APS and PWCC that was provided to the bond rating agencies in early 2001 the same contract for which APS requested a variance from the Rules on October 18, 2001?

A. No. They are different contracts.

ISSUE #3 – PWEC'S CONSTRUCTION OF GENERATING PLANTS TO SERVE APS

Q. Why is the reason that PWEC built certain generating plants important in determining intended non-compliance with the Rules?

A. If PWEC built the plants only to serve APS, it either must have been supremely confident that it would win the competitive bid required by R14-2-1606(B) and the Addendum to the 1999 Settlement Agreement or believed it could somehow circumvent that requirement. Also, APS is asserting that because certain of the PWEC plants were built to serve APS, they should be included in APS' rate base.

Q. How has Mr. Jack Davis testified regarding the purpose of the PWEC plants?

A. In the recent hearings on the financing case, under questioning by APS' attorney, Mr. Mumaw, Mr. Davis (member of the Board of Directors and President of PWCC and member of the Board of Directors and President and Chief Executive Officer of APS) testified as follows:

> Q. Mr. Davis, just to wrap that issue up, it has been your position and your testimony that certain plants were built to serve APS' load and were needed to serve APS load?
>
> A. Absolutely. The plants we called the reliability plants, which are Redhawk 1 and 2, West Phoenix 4 and 5, and Saguaro 3.

Q. Are there any statements made by other PWCC Officers that contradict any of Mr. Davis' testimony?

A. Yes. In 1999, at the generator siting hearing for Redhawk, Mr. Ed Fox, Vice President for Communications, Environment and Safety for PWCC, testified that "These facilities will be merchant plants. They truly will be in the competitive market." I interpret that statement to mean that the Redhawk Units were built to compete in the developing competitive market, not dedicated to serve APS.

Also in an undated document admitted in the Financing hearing as Exhibit P-12, entitled "Generation business Plan 2000" on an unnumbered page, Mr. Bill Stewart addressed the Redhawk Project. He said that "Redhawk is a larger merchant plant consisting of four 530-megawatt units…"

Mr. Stewart also addressed PWEC's business plan that would include a diverse portfolio of generation assets that PWEC would acquire through construction and purchase of existing power plants. He then pointed out the "robust" demand growth in the "western United States, especially in Nevada and in the Arizona-New Mexico-California subregions." He commented that "PWE's [PWEC's] plan is geared to capture part of this growth potential and to put our competitors on notice that we intend to gain a substantial market share in our region." This statement can be easily interpreted to mean that PWEC was positioning itself as a "competitor" in the electricity market and did not envision that the construction and purchase of plants was just to serve APS.

Q. Were other statements made that indicate that the PWEC units were built for both the market and APS?

A. Yes. For example, as early as April 23, 1999, in a press release announcing a short-lived PWCC partnership with Calpine Corporation for generation at West Phoenix, Mr. Bill Post (member of the Board of Directors and President of PWCC and member of the Board of Directors and Chief Executive Officer of APS), at that time representing PWCC, announced: "We are committed to meeting the growing needs of our customers as well as pursuing new opportunities in competitive generation markets."

In Pinnacle West Capital Corporation's SEC Form 10 – K dated March 1999, for the period ending December 31, 1998, under the heading "Competitive Strategies," APS seems to have been contemplating building for both itself and the market as seen in the following quotation from Page 5 (underlining added):

> "APS is pursuing strategies to maintain and enhance its competitive position. These strategies include (i) cost management, with an emphasis on the reduction of variable costs (fuel, operations, and maintenance expenses) and on increased productivity through technological efficiencies; (ii) a focus on APS' core business through customer service, distribution system reliability, business segmentation, and the anticipation of market opportunities; (iii) an emphasis on good regulatory relationships; (iv) asset maximization (e.g., higher capacity factors and lower forced outage rates); (v) *expanding APS' generation asset base to support growth in the competitive power marketing arena* (emphasis added); (vi) strengthening APS' capital structure and financial condition; (vii) leveraging core competencies into related areas, such as energy management products and services; and (viii) establishing a trading floor and implementing a risk management program to provide for more stability of prices and the ability to retain or grow incremental margin through more competitive pricing and risk management. Underpinning APS' competitive strategies are the strong growth characteristics of APS' service territory. As competition in the electric utility industry continues to evolve, APS will continue to evaluate strategies and alternatives that will position us to compete effectively in a more competitive, restructured industry."

Also, at an analyst conference held by PWCC on October 26, 2000, Mr. Post set forth some of the underlying principles of PWCC's strategic plan that implied that APS' strategy was to maintain flexibility in the use of the PWEC assets in the changing electricity market. He said, "We have the flexibility to deal with both regulatory and market challenges." He also said,

> "We have sized our generation expansion plan, when you combine that with our existing generation, to what we think the native load will be, gives us the ability to deal with changes in regulation, the re-regulation of this market. It positions us to be able to get the maximum value out of

> those generating assets." And, "We think that natural hedge, our ability to be able to look at the market from a competitive standpoint and move aggressively from a market point of view, is certainly our preference but as we think about the reaction that's going to come about as a result of the California issues this summer as well as the unwillingness of public power to break the vertical integration that they can uniquely maintain, its going to be difficult to achieve a fully liquid and transparent market in here in the west. That's our first goal."

Q. Why were the contracts (had they been signed) in the best interest of APS, PWEC, and PWCC?

A. With divestiture occurring on or before January 1, 2003, and a purchased power adjustor resulting from the 1999 Settlement Agreement expected to go into place on July 1, 2004, APS knew that it would be exposed to market prices for 18 months without the benefit of the purchased power adjustor. Without a better arrangement, PWEC would have had to sell in the market. Agreements such as those in the draft contracts would have benefited PWEC by having a firm purchaser of all of its power and would benefit APS by sheltering it somewhat from the market.

ISSUE #4 – WAS APS FORBIDDEN TO BUILD ITS OWN PLANTS?

Q. Did Mr. Davis also address the alternative of APS building the plants and then transferring the plants to PWEC?

A. Yes, in the same Financing hearing he said,

> "My testimony is clear to me, in the context of a code of conduct, that Arizona Public Service was prohibited from building new generation within Arizona Public Service, because it wasn't allowed to participate in what was defined in the code of conduct as interim competitive activities. And that needs to be interpreted also in the light of just a whole general policy of the Commission dating back since prior to 1996, they did not want the incumbent vertically integrated utility to own or operate generating facilities….And we think it was in the spirit of the rules and in

> the letter of the code of conduct that Arizona Public Service should not build." Page 520, January 10, 2003 lines 4 through 12 and Page 521 lines 2 through 4.

Q. Provide the Code of Conduct and other language that APS believes prohibited building generators within APS.

A. According to APS' Code of Conduct, Section X, "APS shall not provide Interim Competitive Activities." The Code of Conduct defines Interim Competitive Activities as meaning "Any Competitive Services, exclusive of those set forth in A.A.C. R14-2-1615(B), that APS may lawfully provide until December 31, 2002." Competitive Services are defined as: "all aspects of retail electric services described in A.A.C. R14-2-1601(7). The rule referred to defines Competitive Services as "all aspects of retail electric service except those services specifically defined as "Noncompetitive Services" pursuant to R14-2-1601(29) or noncompetitive services as defined by the Federal Energy Regulatory Commission. Non-competitive services were further defined in A.A.C. R14-2-1601 (30) as including "Distribution Service, Standard Offer Service, transmission and any ancillary services deemed to be non-competitive by the Federal Energy Regulatory Commission, [and] Must-Run Generating Units services."

Q. How do you interpret the excerpts from the Code of Conduct and the Rules as they relate to APS' ability to build generating plants?

A. I interpret them as prohibiting APS from providing certain kinds of retail services but not from engaging in construction activities.

Q. Do you believe that the Code of Conduct foreclosed APS from building generating plants during the period between the implementation of the Rules and January 1, 2003?

A. No, I do not. Even if APS' Code of Conduct were interpreted to prohibit the construction of generation by APS, Section XIV of the Code of Conduct provides a procedure to modify the Code of Conduct by APS filing an application with the Commission setting forth the proposed modifications and the reasons supporting them.

ISSUE #5 --APS' APPLICATION FOR AN AIR QUALITY PERMIT ON BEHALF OF PWEC

Q. The Financing Decision also expressed concern that PWEC may have received an unfair competitive advantage when APS applied for an air quality permit on behalf of PWEC. Please describe the circumstances under which APS applied for the permit.

A. On September 14, 1999, APS filed a Significant Permit Revision Application for the West Phoenix Power Plant. On the date of the application, PWEC did not exist. However, on September 27, 1999, PWEC filed its articles of incorporation and became a legal entity.

To determine the level of competitive advantage that APS' action may have resulted in, Staff asked APS to supply the cost of the application processes and to which PWCC entity's books it was charged. APS responded that the costs related to the air quality permit revisions for West Phoenix CC4, West Phoenix CC5 and Saguaro CT3 totaled $522,705 plus some minor administration costs and that the permit costs were all charged to PWEC and capitalized (LAJ-5.15). Regardless of the ownership or purpose of the plants, ultimately PWEC paid for the permits. Thus, it is doubtful that PWEC benefited significantly from this action on the part of APS.

ISSUE #6 -- APS TRANSFER OF LAND TO PWEC

Q. Who was the previous owner of the land upon which PWEC built the West Phoenix and Saguaro plants?

A. The land was owned by APS. According to APS' response to LCA-3.81, the transfer of its land to PWEC was completed by inter-company journal entries and at book value.

Q. Has PWEC already acknowledged that land ownership might give it a competitive advantage?

A. Yes. A paragraph on page 7 of "Pinnacle West Energy: Business Plan 2001" dated March 15, 2001 and marked as Exhibit P-13 in the Financing case addresses this issue. The paragraph mentions 32,550 megawatts of generation capacity proposed for the Southwest and points out that only a portion of that generation would be built "due to limited availability of transmission and natural gas pipeline capacity and land and water resources." It then goes on to say that "PWEnergy has a competitive advantage because it has acquired the necessary land and water rights and was among the first to break ground in Arizona."

Q. How could this action by APS have inhibited electric competition?

A. If other generation companies that intended to build plants to serve Arizona purchased land at negotiated prices and at full market value while PWEC built on land purchased at a non-negotiated price below market value, the ultimate cost of electricity from those companies, all else held equal, would be higher than the cost of electricity from the PWEC plants.

CONCLUSIONS

Q. **What have you concluded about the actions of PWEC/PWCC/APS as they related to electric competition?**

A. I believe that in PWCC's efforts to maximize and stabilize earnings, PWCC and its affiliates acted in ways, that absent the Track A and B Decisions, would likely have negatively impacted electric competition in Arizona. Those actions included the presentation of draft contracts among APS, PWEC and PWCC to the bond rating agencies thereby increasing PWEC's bond rating and that the contracts were neither the result of competitive bidding nor arms-length transactions. The draft contracts could have assured the purchase of every kilowatt-hour generated by PWEC and significantly limited APS' participation in the electricity market thereby reducing the demand for "independent" power in Arizona. I also believe that the transfer of land from APS to PWEC gave PWEC an unfair advantage, although slight, in the electricity market. Public statements made by officers of PWEC/APS/PWCC are conflicting as to the purpose for which certain PWEC generation plants were built. Finally, the apparently cooperative generation planning and building activities between and among APS, PWEC and PWCC would also have given PWEC an unfair advantage in the competitive markets.

Q. Were customers harmed by APS' actions?

A. No. From 1999 through 2004, the customers have been protected by a prohibition on rate increases adopted as part of the 1999 Settlement Agreement. Therefore, any actions by APS that may have given PWEC a competitive advantage did not affect APS customers.

Q. Does this conclude your direct testimony?

A. Yes, it does.