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**BEFORE THE ARIZONA CORPORATION COMMISSION**

COMMISSIONERS

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

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

DECISION NO. \_\_\_\_\_

**OPINION AND ORDER**

DATES OF PROCEDURAL  
CONFERENCES :

August 13, 2003, January 6, February 18, April 7, 15, 28  
May 26, June 14, August 18, and October 27, 2004

DATES OF HEARING:

November 8, 9, 10, 29, 30, December 1, 2, and 3, 2004

PLACE OF HEARING:

Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE:

Lyn Farmer

IN ATTENDANCE:

Marc Spitzer, Chairman  
William A. Mundell, Commissioner  
Jeff Hatch-Miller, Commissioner  
Mike Gleason, Commissioner  
Kristin K. Mayes, Commissioner

APPEARANCES:

Mr. Thomas L. Mumaw and Ms. Karilee S. Ramaley,  
PINNACLE WEST CAPITAL CORPORATION; Mr.  
Jeffrey B. Guldner and Ms. Kimberly Grouse, SNELL  
& WILMER, L.L.P., on behalf of Arizona Public  
Service Company;

Mr. C. Webb Crockett, FENNEMORE CRAIG, P.C., on  
behalf of AECC and Phelps Dodge;

Mr. Patrick J. Black, FENNEMORE CRAIG, P.C., on  
behalf of Panda Gila River;

Mr. S. David Childers, LOW & CHILDERS, P.C., Mr.  
James M. Van Nostrand, and Ms. Katherine McDowell  
STOEL RIVES, L.L.P., on behalf of Arizona  
Competitive Power Alliance;

Mr. Lawrence V. Robertson, Jr., MUNGER

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CHADWICK, on behalf of Southwestern Power Group II, Mesquite Power, and Bowie Power Station, LLC, and Mr. Theodore Roberts, SEMPRA ENERGY RESOURCES, on behalf of Mesquite Power;

Mr. Scott S. Wakefield, Chief Counsel, and Mr. Daniel Pozefsky, on behalf of the Residential Utility Consumer Office;

Mr. Walter W. Meek, President, on behalf of the Arizona Utility Investors Association;

Mr. Raymond S. Heyman, Ms. Laura E. Schoeler, and Ms. Laura Sixkiller, ROSHKA, HEYMAN & DeWULF, on behalf of UniSource Energy Services;

Major Allen G. Erickson on behalf of the Federal Executive Agencies;

Mr. Jay I. Moyes, MOYES STOREY, on behalf of PPL Sundance and PPL Southwest Generation Holdings;

Mr. Nicolas J. Enoch, LUBIN & ENOCH, on behalf of the International Brotherhood of Electrical Workers;

Mr. William P. Sullivan and Mr. Michael A. Curtis, MARTINEZ & CURTIS, P.C., on behalf of the Town of Wickenburg, Arizona;

Mr. Bill Murphy, MURPHY CONSULTING and Mr. Douglas V. Fant, LAW OFFICES OF DOUGLAS V. FANT, on behalf of the Arizona Cogeneration Association;

Mr. Marvin S. Cohen, SACKS TIERNEY, P.A., on behalf of Constellation NewEnergy and Strategic Energy;

Mr. Andrew W. Bettwy and Ms. Karen S. Haller, on behalf of Southwest Gas Corporation;

Mr. Timothy M. Hogan, ARIZONA CENTER FOR LAW IN THE PUBLIC INTEREST, and Ms. Anne C. Ronan, on behalf of Western Resources Advocates and Southwest Energy Efficiency Project;

Mr. Jesse A. Dillon, on behalf of PPL Services Corporation;

Mr. Brian Babiars and Ms. Cynthia Zwick, WESTERN ARIZONA COUNCIL OF GOVERNMENTS, on behalf of Arizona Community Action Association;

Mr. Paul R. Michaud, MICHAUD LAW FIRM, on behalf of Dome Valley Energy Partners, LLC;

Mr. Michael L. Kurtz, BOEHM, KURTZ & LOWRY,  
on behalf of Kroger Company;

Mr. Christopher Kempley, Chief Counsel, Mr. Jason D.  
Gellman and Ms. Janet F. Wagner, Attorneys, Legal  
Division, on behalf of the Utilities Division of the  
Arizona Corporation Commission.

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**BY THE COMMISSION:****I. DISCUSSION**

1  
2  
3 On June 27, 2003, Arizona Public Service Company (“APS” or “Company”) filed with the  
4 Arizona Corporation Commission (“Commission”) an application for a rate increase and for approval  
5 of a purchased power contract. The application states that the \$175.1 million rate increase is needed  
6 to maintain the Company’s credit ratings and attract new capital on reasonable terms, recover its cost  
7 of service, and permit APS to earn a fair rate of return on the fair value of its assets devoted to public  
8 service. The application requested that the Commission recognize the higher fuel and purchased  
9 power expenses being incurred by the Company; allow APS to include in rates at cost of service  
10 certain generation assets of Pinnacle West Energy Corporation (“PWEC”); permit APS to recover the  
11 \$234 million write-off taken under the 1999 Settlement Agreement; and provide for the recovery of  
12 all prudently incurred costs to comply with the Commission’s Retail Electric Competition Rules,  
13 A.A.C. R14-2-1601, *et seq.* (“Electric Competition Rules”), including the one-third of costs  
14 associated with the planned divestiture of generation from APS to PWEC that was not previously  
15 deferred. APS also requested approval of depreciation and amortization rates and a review of its  
16 long-term purchased power contract with PWEC if the assets are not rate based.

17 On July 25, 2003, the Utilities Division Staff (“Staff”) of the Commission filed a letter stating  
18 that the application was found sufficient and classified the applicant as a Class A utility.

19 By Procedural Order issued August 6, 2003, a Procedural Conference was scheduled for  
20 August 13, 2003, and intervention was granted to the Arizonans for Electric Choice and Competition  
21 (“AECC”), the Federal Executive Agencies (“FEA”), the Kroger Company (“Kroger”), the  
22 Residential Utility Consumer Office (“RUCO”), the Arizona Utility Investors Association, Inc.,  
23 (“AUIA”) and Phelps Dodge Corporation and Phelps Dodge Mining Company (“Phelps Dodge”).

24 By various Procedural Orders, intervention was granted to: the International Brotherhood of  
25 Electrical Workers, AFL-CIO, CLC, Local Unions 387, 640 and 769 (collectively, “IBEW”), the  
26 Arizona Cogeneration Association/Distributed Generation Association of Arizona (“ACA” or  
27 “DEAA”), Panda Gila River, L.P. (“Panda”), Arizona Water Company (“AWC”), Southwest Gas  
28 Corporation (“SWG”), Western Resource Advocates (“WRA”), Constellation NewEnergy, Inc.

1 (“CNE”), Strategic Energy, L.L.C. (“SEL”), Dome Valley Energy Partners, LLC (“DVEP”),  
 2 UniSource Energy Services (“UES”), Arizona Community Action Association (“ACAA”), Arizona  
 3 Competitive Power Alliance (“Alliance”), the Town of Wickenburg (“Wickenburg”)<sup>1</sup>, the Arizona  
 4 Solar Energy Industries Association (“AriSEIA”), the Arizona Association of Retired Persons  
 5 (“AARP”), Southwest Energy Efficiency Project (“SWEEP”), PPL Sundance, LLC (“PPL  
 6 Sundance”), PPL Southwest Generation Holdings, LLC (“PPL Southwest”), Southwestern Power  
 7 Group II, LLC (“SWPG”), Mesquite Power, LLC (“Mesquite”) and Bowie Power Station, LLC  
 8 (“Bowie”).

9 On November 5, 2003, Staff filed a Motion to Consolidate (“Motion”) the preliminary inquiry  
 10 created by Decision No. 65796 and by Procedural Order the Motion was granted, authorizing Staff to  
 11 include its report in this docket.

## 12 **II. PRE-SETTLEMENT POSITIONS OF PARTIES**

	APS	Staff	RUCO	Settlement Agreement
13 Revenue requirement	+\$175.1 M	-\$142.7 M	-\$53.6 M	+\$75.5 M
14 Return on Equity	11.5 %	9.0%	9.5%	10.25 %
15 Debt cost	5.8 %	5.8%	5.8%	5.8%
16 Capital Structure	50/50	55/45	55/45	55/45
17 Cost of Capital	8.67 %	7.3%	7.43%	7.8 %
18 PWEC assets	\$848 M	-	- <sup>2</sup>	\$700 M

## 20 **III. SETTLEMENT AGREEMENT**

### 21 **a. Introduction**

22 On August 18, 2004, a Settlement Agreement signed by 22 parties<sup>3</sup> was docketed with the  
 23 Commission. AWC, SWG, and UES do not oppose the Settlement Agreement, and the AARP made  
 24 public comment supporting it. The only party opposed to the Commission’s adoption of the  
 25 Settlement Agreement that presented testimony and evidence is the Arizona Cogeneration  
 26

27 <sup>1</sup> On August 18, 2004, Wickenburg moved to withdraw its intervention.

<sup>2</sup> Phase I.

28 <sup>3</sup> APS, ACAA, Alliance, AECC, AriSEIA, AUIA, Bowie, CNE, DVEP, FEA, IBEW, Kroger, Mesquite, Phelps Dodge, PPL Southwest, PPL Sundance, RUCO, SWEEP, SWPG, Staff, SEL, and WRA.

1 Association/Distributed Generation Association of Arizona.<sup>4</sup>

2 APS' central objectives in settling were to preserve the company's financial integrity;<sup>5</sup> resolve  
3 the issue of asset "bifurcation"; and to determine the company's future public service obligations.

4 Staff believes that the Settlement Agreement is in the public interest because: it is fair to  
5 ratepayers because it precludes inappropriate utility profits and results in just and reasonable rates; it  
6 is fair to the utility because it provides revenues necessary to provide reliable electric service along  
7 with an opportunity for a reasonable profit; the proposal balances many diverse interests including  
8 those of low-income customers, the renewable energy sector, Demand Side Management ("DSM")  
9 advocates, merchant generators, and retail energy marketers; it allows APS to rate base the PWEC  
10 assets, which are the generating plants originally built by APS' affiliate, PWEC, at a value that is  
11 significantly below their book value; potentially anti-competitive effects that may be associated with  
12 rate basing the PWEC assets are addressed through a self-build moratorium, a competitive  
13 solicitation in 2005, through workshops to address future resource planning and acquisition issues,  
14 and by adopting cost-based unbundling for generation and revenue cycle services in the rate design  
15 for general service customers, encouraging those customers to shop for competitive services; the  
16 Settlement Agreement resolves long, complex litigation by resolving issues associated with prior  
17 Commission decisions that are on appeal; the Settlement Agreement facilitates the provision of  
18 electric service at the lowest reasonable rates; it provides additional discounts to low-income APS  
19 customers, increases funding for advertising these discounts, and increases funding for APS' low-  
20 income weatherization program; and because it includes a comprehensive DSM proposal intended to  
21 foster the development of new DSM programs while ensuring that the expenditures will be  
22 reasonable and subject to appropriate Commission oversight.<sup>6</sup>

23 RUCO noted that this rate case allowed sufficient opportunity for it to fully audit the  
24 Company's cost-of-service study and allowed all parties to be included in the negotiations. RUCO  
25 points to the very substantial, nearly universal consensus reached in the Settlement Agreement as

26 \_\_\_\_\_  
27 <sup>4</sup> New Harquahala Generating Company, LLC and Panda made statements objecting to the rate basing of the PWEC  
assets.

28 <sup>5</sup> Defined as the ability to attract capital on reasonable terms and earn a reasonable return. Tr. p. 420.

<sup>6</sup> Summary of settlement testimony of Ernest Johnson.

1 indicating that the public interest has been served. According to RUCO, the “ultimate expression of  
2 the agreement having met the Public Interest is the degree to which rate increases have been  
3 minimized without jeopardizing the financial integrity of the applicant.”<sup>7</sup>

4 The Alliance’s central objective is to continue towards a viable and effective wholesale  
5 market into which Alliance members can sell their power. According to the Alliance, there are  
6 several key provisions in the Settlement Agreement that accomplish that goal: the restrictions on  
7 self-build coupled with the high growth rate in APS’ service territory; and the 1,000 megawatt  
8 Request for Proposal (“RFP”) in 2005. The Settlement Agreement also preserves the financial  
9 stability and creditworthiness of the Alliance’s target customer – APS.<sup>8</sup>

10 **b. Revenue Requirements**

11 For ratemaking purposes and for purposes of the Settlement Agreement, the parties agree that  
12 APS will receive a total increase of \$75.5 million over its adjusted 2002 test year (“TY”) revenue of  
13 \$1,791,584,000. This represents an increase in base rates of \$67.6 million and a Competition Rules  
14 Compliance Charge (“CRCC”) surcharge collecting \$7.9 million. Pursuant to the Settlement  
15 Agreement filed on August 18, 2004, as corrected in the hearing, the Company’s fair value rate base  
16 (“FVRB”) is \$5,054,426,000.<sup>9</sup> According to the Settlement Agreement, this revenue increase will  
17 allow the Company the opportunity to earn a fair value rate of return of 5.92 percent. According to  
18 the Company and Staff, the revenue requirement contained in the Settlement Agreement provides  
19 sufficient revenues for APS to provide adequate and reliable service.<sup>10</sup>

20 **c. PWEC Asset Treatment**

21 The Settlement Agreement provides that APS will acquire and rate base generation units  
22 owned by PWEC.<sup>11</sup> Those units include: West Phoenix CC-4; West Phoenix CC-5; Saguaro CT-3;  
23 Redhawk CC-1; and Redhawk CC-2 (“PWEC assets”). Pursuant to the Settlement Agreement, the

24 \_\_\_\_\_  
25 <sup>7</sup> Summary of settlement testimony of Stephen Ahearn.

26 <sup>8</sup> Tr. p. 458.

27 <sup>9</sup> Paragraph 4 to the Settlement Agreement states the FVRB is \$6,281,885,000, however, during the hearing, that amount  
28 was corrected to \$5,054,426,000. Tr. p. 692.

<sup>10</sup> Tr. p. 810.

<sup>11</sup> On November 10, 2004, PWEC filed a letter with the Commission indicating that it would abide by the provisions of  
the Settlement Agreement that require PWEC to take or refrain from taking any action in order to carry out the intent of  
the Settlement Agreement.

1 original cost rate base (“OCRB”) of the PWEC assets will be \$700 million which is \$148 million less  
2 than the original cost of the assets as of December 31, 2004. According to the Settlement Agreement,  
3 this represents a reasonable estimate of the value of the remaining term of the Track B contract  
4 between APS and PWEC.<sup>12</sup> APS agrees to forgo any present or future claims of stranded costs  
5 associated with these PWEC assets. According to the Settlement Agreement, APS is required to seek  
6 approval of certain aspects of the asset transfer from the Federal Energy Regulatory Commission  
7 (“FERC”). APS agreed to file a request for FERC approval within 30 days of the Commission’s  
8 approval of the Settlement Agreement, and the parties have agreed not to oppose the FERC  
9 application. The Settlement Agreement provides for a bridge purchased power agreement (“Bridge  
10 PPA”) to be implemented once new rates are put in place, until the actual date of the transfer of  
11 assets. APS and PWEC will execute a cost-based PPA which will be based on the value of the  
12 PWEC assets, and fuel costs and off-system sales revenue will flow into the power supply adjustor  
13 (“PSA”). If FERC denies the asset transfer, then the Bridge PPA will become a 30 year PPA, with  
14 prices reflecting cost-of-service as if the PWEC assets were rate-based at the \$700 million amount in  
15 the Settlement Agreement, and with the associated fuel costs and off-system sales revenue flowing  
16 through the PSA. The basis point credit established in Decision No. 65796 will continue as long as  
17 the debt between APS and PWEC associated with the PWEC assets is outstanding. Credit for  
18 amounts deferred after December 31, 2004 will be accounted for in APS’ next rate case. The  
19 Settlement Agreement also provides that West Phoenix CC-4 and West Phoenix CC-5 will be  
20 deemed “local generation” and during must-run conditions, generation from the West Phoenix  
21 facilities will be available at FERC-approved cost-of-service prices to electric service providers  
22 (“ESPs”) serving direct access loads in the Phoenix load pocket.

23 Treatment of the PWEC assets requires not only a regulatory ratemaking type analysis, but  
24 also an analysis of how rate basing these assets fits with the Commission’s overall plan for wholesale  
25 and retail electric competition in Arizona.

26 For the last ten years, the Commission has studied, discussed, and deliberated about electric  
27

28 <sup>12</sup> Docket Nos. E-01345A-03-0437 et al.

1 competition through workshops, rulemakings, hearings, and open meetings. Several versions of  
2 electric competition rules have been adopted, and litigation concerning Commission decisions has  
3 been conducted. Throughout this time, the Commission has always maintained its intent to  
4 encourage competition in the electric industry. APS' request and the Settlement Agreement's  
5 provision allowing APS to acquire the PWEC assets and put them in rate base raises the issue of  
6 whether such action would undermine the stated intent to encourage retail and wholesale competition.  
7 The terms of the Settlement Agreement taken as a whole indicate to us that the answer to that  
8 question is "no".

9       During the hearing on the Settlement Agreement, the parties presented evidence  
10 demonstrating that the PWEC acquisition was the most beneficial option for ratepayers. Staff  
11 testified that the responses to APS' last formal RFP did not indicate to Staff that the market would  
12 provide a superior alternative to the rate basing of the PWEC assets. The testimony indicates that  
13 growth in APS' service territory is a minimum of 3 percent per year. APS argued that even with rate  
14 basing the PWEC assets, APS' needs would not be met, and it would have to procure additional  
15 power to meet the needs of its customers. The Settlement Agreement provides that APS will issue an  
16 RFP for an additional 1000 megawatts, thereby giving other market participants an opportunity to  
17 compete. The organization created to represent the interests of the merchant community, the  
18 Alliance, supports the transfer of assets, because it believes that resolving the broader issues of  
19 overall market structure, the self-build guidelines and future RFPs, together with the reduction in  
20 litigation risk will further its overall goal of promoting a viable and effective wholesale market. The  
21 key provision that the Alliance relies on is the 1,000 megawatt RFP in 2005 that provides a degree of  
22 certainty regarding the timing of an initial increment of APS' future needs to be met from the  
23 wholesale market. Also, the Alliance believes that opportunities will exist for its members because of  
24 the self-build limitation and the high growth rate in Arizona. The proponents of retail competition  
25 also support the asset transfer; in large part because APS agrees to forgo any present or future claims  
26 of stranded costs associated with the PWEC assets, because rates are unbundled, and because of the  
27 treatment of the West Phoenix facilities.

28       We believe that nothing in the Settlement Agreement prevents the continued development of

1 electric competition. Any potential anti-competitive effects of the asset transfer will be addressed  
2 through the competitive solicitations, the self-build moratorium,<sup>13</sup> and Staff's workshops to address  
3 future resource planning and acquisition issues. As discussed below, the evidence indicates that the  
4 asset transfer captures the benefit of the competitive procurement that took place as a result of the  
5 Track B proceeding.

6         The original cost of the PWEC assets at December 31, 2004 was \$848 million. Traditionally,  
7 when a utility builds plant, unless there is a finding of imprudence, that portion of the plant that is  
8 used and useful is put into rate base and the utility is allowed an opportunity to earn a reasonable rate  
9 of return on that investment. This situation is different from the traditional rate case. APS did not  
10 build the PWEC assets; they were built by APS' affiliate during a time when the Commission  
11 intended APS to divest itself of generation. During the proceeding on APS' financing application,  
12 concern was raised that APS and its affiliates took actions that gave it an unfair advantage as  
13 compared to its potential competitors. In Decision No. 65796, which granted APS' financing request,  
14 we directed Staff to conduct a preliminary inquiry into the issue of APS and its affiliate's compliance  
15 with our electric competition rules, Decision No. 61973, and applicable law. The Settlement  
16 Agreement provides that the preliminary inquiry will be concluded with no further action by the  
17 Commission. Accordingly, we make no finding as to why or for whom the PWEC assets were built,  
18 and base our resolution of the rate basing issue solely on the merits of the terms of acquisition. We  
19 believe that if there were a serious threat to competition, we would hear from those affected, loudly  
20 and strongly. Therefore, we were keenly interested in the position of the members of the Alliance, as  
21 they are one type of entity that could be harmed. The Alliance supports the acquisition of the PWEC  
22 assets by APS. Every person or entity that will be affected by the rate basing of the PWEC assets had  
23 the opportunity to participate and present evidence and testimony on this issue. Although two  
24 independent power producers made comments objecting to the acquisition without an RFP, neither  
25 presented any evidence that demonstrated that competition would be harmed, nor rebutted the

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26  
27 <sup>13</sup> Neither APS nor PWEC will build the Redhawk Units 3 & 4. PWEC's February 2003 self-certification filing with the  
28 Commission stated that the two remaining units pursuant to its Certificate of Environmental Compatibility ("CEC")  
would not be built. Tr. pp. 594-5.

1 testimony and evidence concerning APS' recent RFP.

2       Initially Staff recommended that the PWEC assets not be rate based, but after analyzing the  
3 Company's rebuttal testimony and evidence, agreed that a reduction of \$148 million in original cost  
4 rate base made the acquisition beneficial to ratepayers. The evidence in the record is substantial that  
5 APS' analysis of other options versus rate basing PWEC assets showed that: using an "other build"  
6 analysis, rate basing the PWEC assets would cost \$300-600 million less than cost to build other  
7 plants such as Combustion Turbines ("CT"); using a comparable sales analysis showed that other  
8 recent sales had a per kW cost in excess of \$527 and the PWEC assets are at \$417; when compared to  
9 the offers resulting from the recent RFP conducted by APS, the PWEC assets (when valued at the  
10 before discount \$848 million level) showed benefits of \$600-900 million; and using a discounted  
11 cash flow analysis the PWEC assets had a savings of \$250 million to \$1 billion.

12       As part of the settlement, APS agreed to reflect an original cost rate base value of \$700  
13 million, representing a \$148 million disallowance. The effect of a reduction in rate base is to  
14 immediately reduce the revenue requirement, and to preserve that diminished revenue requirement  
15 for the life of the plant.

16       The analyses showing that the rate basing of the PWEC assets will result in lower rates than  
17 other options, together with no showing that such an acquisition would harm the development of a  
18 competitive wholesale or retail market indicate that it is reasonable and in the public interest for APS  
19 to acquire and rate base the PWEC assets as set forth in the Settlement Agreement.

20 **d. Cost of Capital**

21       The Settlement Agreement adopts a capital structure of 55 percent long-term debt and 45  
22 percent equity for ratemaking purposes. The parties agree that a 10.25 percent return on common  
23 equity and a 5.8 percent embedded cost of long-term debt is appropriate.

24 **e. Power Supply Adjustor (PSA)**

25       The Settlement Agreement provides that a PSA be implemented and remain in effect for a  
26 minimum of five years, with reviews available during APS' next rate case, or upon APS' filing its  
27 report on the PSA four years after rates are implemented in this rate case. Regardless of the  
28 review/report, the PSA cannot be abolished until five years have expired. The Settlement Agreement

1 provides that APS will file a plan of administration as part of its tariff filing that describes how the  
2 PSA will operate. According to the Settlement Agreement, the PSA will have the following  
3 characteristics:

- 4 • Includes both fuel and purchased power;
- 5 • The adjustor rate will initially be set at zero and will thereafter be reset on April 1 of each  
6 year, beginning with April 1, 2006. APS will submit a publicly available report on March 1  
7 showing the calculation of the new rate, which will become effective unless suspended by the  
8 Commission;
- 9 • Incentive mechanism where APS and its customers share 10 percent and 90 percent,  
10 respectively, the costs and savings;
- 11 • Bandwidth that limits annual change in adjustor of plus or minus \$0.004 per kilowatt hour,  
12 with additional recoverable or refundable amounts recorded in balancing account;
- 13 • Surcharge possible if balancing account reaches plus or minus \$50 million and Commission  
14 approves;
- 15 • Off-system sales margins credited to PSA balance;
- 16 • Recovery of prudent, direct costs of contracts for hedging fuel and purchased power costs;
- 17 • Interest on balancing account will accrue based on the one-year nominal Treasury constant  
18 maturities rate;
- 19 • The Commission or its Staff may review the prudence of fuel and power purchases at any  
20 time;
- 21 • The Commission or its Staff may review any calculations associated with the PSA at any  
22 time; and
- 23 • Any costs flowed through the adjustor are subject to refund if the Commission later  
24 determines that the costs were not prudently incurred.

25 The Settlement Agreement provides that APS shall provide monthly reports to Staff's  
26 Compliance Section and to RUCO detailing all calculations related to the PSA, and shall also provide  
27 monthly reports to Staff about APS' generating units, power purchases, and fuel purchases. An APS  
28 officer must certify under oath that all the information provided in the reports is true and accurate to

1 the best of his or her information and belief. The Settlement Agreement also provides that direct  
2 access customers and customers served under rates E36, SP-1, Solar-1, and Solar-2 are excluded  
3 from paying PSA charges. Under the Settlement Agreement, the PSA remains in effect for 5 years,  
4 and if after that, the Commission abolishes the PSA, it must provide for any under- or over-recovery  
5 and can adjust base rates to reflect costs for fuel and purchased power. The parties agree that a base  
6 cost of fuel and purchased power of \$.020743 per kWh should be reflected in APS' base rates.

7 Decision No. 61973 (October 6, 1999) adopting the previous APS settlement, required APS to  
8 request, and the Commission to approve, a "power supply adjuster" mechanism to recover the cost of  
9 providing power for standard offer and/or provider of last resort customers.

10 In Decision No. 66567 (November 18, 2003), the Commission approved the concept of a  
11 Purchased Power Adjustor ("PPA") which included purchased power costs and did not include the  
12 cost of fuel. The Decision noted that the adjustor mechanism approved therein may be modified or  
13 eliminated in this rate case. As noted in that Decision, there are advantages and disadvantages to  
14 adjustor mechanisms:

15 Advantages: 1) the reporting requirements and forecasts facilitate utility planning and Staff  
16 overview of costs; 2) an adjustor that works correctly, over time, reduces the volatility of a utility's  
17 earnings and the risk reduction can be reflected in the cost of equity capital in a rate case and result in  
18 lower rates; 3) adjustors can create price signals to consumers, but the effectiveness is reduced  
19 considerably when a band is included; 4) adjustors can help reduce the frequency of rate cases; 5)  
20 regulatory lag between the incurrence of an expense and its recovery is reduced and generational  
21 inequities are also reduced.

22 Disadvantages: 1) adjustors can reduce incentives to minimize costs; 2) an adjustor that  
23 includes fuel or purchased power costs potentially biases capital investment decisions towards those  
24 with lower capital costs and higher fuel costs; 3) adjustors create another layer of regulation to rate  
25 cases, increasing the cost of regulation to the utility, its customers, and to the Commission; 4) an  
26 adjustor can shift a disproportionate proportion of the risk of forced outages and systems operations  
27 from shareholders to ratepayers; 5) adjustors result in piecemeal regulation – an adjustor reflects an  
28 increase in one expense but ignores offsetting savings in other costs; 6) adjustors are complex and

1 often difficult for analysts to read and interpret, and are difficult to explain to customers; 7) proper  
2 monitoring of adjustor filings and audits require the devotion of significant Staff resources; and 8)  
3 rates are less stable, resulting in rates changing frequently, making it difficult for customers to plan  
4 energy consumption and the purchase of energy consuming appliances.

5         Although we recently approved the concept of a PSA, we are concerned about the PSA as  
6 proposed in the Settlement Agreement. The benefits of this PSA are that over time, the utility's  
7 earnings will be stabilized, thereby preserving its financial integrity and in the longer term, improve  
8 the likelihood that the company will attract capital on reasonable terms, to the benefit of ratepayers.  
9 Further, as part of the negotiations, the parties were able to agree on a lower overall revenue increase  
10 because a PSA was to be implemented. AECC pointed out that if an adjustor remains in effect for  
11 long enough, it becomes a credit, and therefore, the PSA should remain in effect for five years.<sup>14</sup>

12         The disadvantages are real and significant – from a customer standpoint, adjustors are  
13 difficult to understand and they can cause annual price increases. From a regulatory standpoint, they  
14 require significant Commission staff resources to properly monitor filings, costs, and compliance and  
15 to respond to consumer inquiries and complaints. The most significant change that will occur with a  
16 PSA is the shifting of the risk that fuel costs will increase above the base rates established in the  
17 Settlement Agreement. Currently, if fuel costs or any other costs rise above the level embedded in  
18 the existing rate structure, the company's shareholders feel the impact. Likewise, if the costs  
19 decrease, the shareholders benefit. Under a PSA, the shareholders are insulated from the change in  
20 costs, because now the ratepayers are obligated to pay the additional costs. Further, the testimony  
21 was clear that costs are going to be increasing, not only because natural gas prices will increase, but  
22 also because APS' "mix" of fuel will change as growth occurs.<sup>15</sup> That mix will include an increasing  
23 amount of natural gas to supply the new generation. When compared to APS' other fuel sources such  
24 as nuclear or coal, natural gas is a substantially higher cost fuel. So here, the PSA will not only be

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26 <sup>14</sup> Tr. p. 1249.

27 <sup>15</sup> As growth occurs, the per unit cost of fuel will increase. Tr. p. 1238. Currently, nuclear is 32 percent of sales and  
28 represents 7.4 percent of the costs of generation; coal is 45 percent of sales and 29.7 percent of generation costs; natural  
gas is 18 percent of sales and 47.4 percent of generation costs; and purchased power is 5 percent of sales and 15.5 percent  
of generation costs. Tr. p. 1257. In five years, natural gas is expected to be 29-30 percent of sales. TR. p. 1258.

1 collecting additional revenues due to fuel price increases, but also increases due to growth that is met  
2 with generation from a high cost fuel.<sup>16</sup>

3         Although the Settlement Agreement provides that APS will increase its demand side  
4 management and renewables, and we agree that those resources are increasingly important, they will  
5 not likely have a significant ameliorating cost impact in the near future. We disagree with the parties  
6 that a 90/10 sharing is sufficient incentive for APS to continue to effectively hedge its natural gas  
7 costs. Going from a 100 percent at-risk position to 10 percent at-risk almost seems like a “free pass,”  
8 especially when a revenue increase is added. Although the Settlement Agreement provides that all  
9 costs will be subject to review for prudence before they can be recovered, prudence reviews,  
10 especially transactions in the wholesale market, can be difficult to conduct after the fact. Although  
11 we have confidence in our Staff’s ability to conduct prudence reviews, we do not believe they  
12 provide as much incentive to APS on the front end to hedge costs as exists today without a PSA. The  
13 band-width limit will help limit drastic increases, but ultimately, APS will be able to recover all the  
14 costs from ratepayers.<sup>17</sup>

15         Accordingly, for these reasons, we believe that provisions of the PSA need to be modified to  
16 protect the ratepayers. We will limit the amount of “annual gas costs” that can be used to calculate  
17 the annual PSA to no more than \$500,000,000 – as shown in Staff Exhibit 23.<sup>18</sup> Any gas costs above  
18 that level will not be recovered from ratepayers through the PSA. We believe that this “cap” on gas  
19 costs will further encourage APS to manage its costs, and will help to prevent large account balances  
20 from occurring in one year. Since there is no moratorium on filing a rate case, APS can file a rate  
21 case to reset base rates if it deems it necessary because that cap is reached. Further, although the  
22 Settlement Agreement provides that the PSA will be in effect for 5 years, if APS files a rate case  
23 prior to the expiration of that 5 year term or if we find that APS has not complied with the terms of  
24 the PSA, we believe that the Commission should be able to eliminate the PSA if appropriate.

25 \_\_\_\_\_  
26 <sup>16</sup> See discussion Tr. p. 1259, PSA will always be increasing.

27 <sup>17</sup> Staff’s late-filed exhibit S-35 filed December 14, 2004 in response to a request from Commissioner Mundell to  
28 extrapolate the effects of the PSA over several years, appears to have an error in that it deducts the amount recovered  
through the adjustor during the previous year from the current year’s balance to be collected during the following year’s  
PSA charge.

<sup>18</sup> For example, under “Average Usage Scenario One”, the line reads “Annual Gas Cost: \$248,400,000.”

1 Finally, we will not allow any fuel costs from 2005 that were incurred prior to the effective date of  
2 this Decision to be included in the calculation of the PSA implemented in 2006. We believe that these  
3 additional provisions to the PSA will help to lessen the detrimental impact to ratepayers of this  
4 change to an adjustor mechanism.

5 Implementing an adjustor mechanism will have a significant impact upon both APS and its  
6 customers. For many years now, in their monthly bills, APS customers have paid rates that reflect  
7 the costs that APS is allowed to recover for providing that service. With the implementation of an  
8 adjustor, those ratepayers will be obligated to pay additional amounts for service they received in the  
9 previous year. This represents a major shift in responsibility for increased costs, from APS and its  
10 shareholders to ratepayers. According to APS, such a shift is necessary for the company to preserve  
11 its financial integrity.

12 Although the parties submitted a written statement describing the calculation of off-system  
13 sales in response to a question from Commissioner Mundell, we are concerned that the method may  
14 not capture the full margin on each sale.<sup>19</sup> Additionally, we want to make sure that off-system sales  
15 are not being made below costs – Staff needs to study ways to insure that these off-system sales  
16 margins are being determined accurately and that ratepayers are receiving the full 90 percent of the  
17 benefits. Accordingly, we will direct Staff to establish a method that accurately reflects the  
18 appropriate fuel costs and revenue for off-system sales, so that the full margin is known and properly  
19 accounted for.

20 In response to Commissioner Gleason’s suggestion to set up a webpage explaining its bill,  
21 APS indicated that it was planning to have a new bill format, and agreed to also set up a website to  
22 explain the bills. Because the implementation of an adjustor will be a major change in the way that  
23 customers are billed, we believe that APS should also implement a customer education program  
24 explaining how its PSA will work and we will order APS to maintain on its website information  
25 explaining the billing format, rates, and charges, including up-to-date information about the PSA and

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26 <sup>19</sup> For example, a wholesale contract may have an embedded cost of fuel built into the price of the energy that is different  
27 from the cost of fuel use to generate the energy – if the “sales margin” is defined as the difference between the actual cost  
28 of fuel and the revenue from the sale, the true sales margin will not be captured. We also take administrative notice of  
FERC Docket No. PA04-11-000 and the FERC’s December 16, 2004 Order Approving Audit Reports and Directing  
Compliance Actions, specifically relating to treatment of off-system sales.

1 current gas costs.

2 Finally, given our concerns and the modifications we require to the PSA, we will require APS  
3 to submit its PSA Plan of Administration for our approval.

4 **f. Depreciation**

5 The Settlement Agreement adopts Staff’s recommended service lives, and Appendix A to the  
6 Settlement Agreement sets forth the remaining service lives, net salvage allowance, annual  
7 depreciation rates, and reserve allocation for each category of APS depreciable property as agreed to  
8 by the parties. The parties agree that the Statement of Financial Accounting Standards (“SFAS”) 143  
9 will not be adopted for ratemaking purposes.

10 **g. \$234 Million Write-Off**

11 The Settlement Agreement provides that APS will not recover the \$234 million write-off  
12 attributable to Decision No. 61973 in this case, nor shall APS seek to recover the write-off in any  
13 subsequent proceeding. The ESP and large consumer witnesses testified that this provision was  
14 critical to the development of flourishing retail markets and will help direct access service from being  
15 undercut by future stranded costs claims.

16 **h. Demand Side Management (“DSM”)**

17 Demand-side management (“DSM”) is “the planning, implementation, and evaluation of  
18 programs to shift peak load to off-peak hours, to reduce peak demand (kW), and to reduce energy  
19 consumption (kWh) in a cost-effective manner.”<sup>20</sup>

20 DSM is addressed in three areas of the Settlement Agreement: in the funding, programs,  
21 plans and reporting provisions; in the study of rate design modifications; and in the competitive  
22 procurement process.

23 Funding for DSM comes in both base rates (\$10 million per year) and through  
24 implementation of an adjustor (average of \$6 million per year).<sup>21</sup> DSM funding will be used for  
25 “approved eligible DSM-related items,” including “energy-efficiency DSM programs,”<sup>22</sup> a

26 \_\_\_\_\_  
27 <sup>20</sup> Direct testimony of Barbara Keene, February 3, 2004.

<sup>21</sup> APS will spend at least \$48 million during calendar years 2005-2007.

28 <sup>22</sup> “Energy-efficient DSM” is defined as “the planning, implementation and evaluation of programs that reduce the use of  
electricity by means of energy-efficiency products, services, or practices.” Settlement Agreement par. 40.

1 performance incentive,<sup>23</sup> and low income bill assistance.<sup>24</sup> APS is obligated to spend \$13 million in  
2 2005 on DSM projects.<sup>25</sup>

3 Appendix B to the Settlement Agreement is a preliminary plan (“Preliminary Plan”) for  
4 eligible DSM-related items for 2005. The Preliminary Plan includes \$6.9 million for commercial,  
5 industrial, and small business customer programs, including new construction, retrofitting existing  
6 facilities, training and education, design assistance, and financial incentives; it includes \$6.2 million  
7 for residential customers, including new construction and existing homes and HVAC, education,  
8 training, expanded low income weatherization, and bill assistance; \$1.3 million for measurement,  
9 evaluation, and research; and \$1.6 million for performance incentive.<sup>26</sup> Within 120 days of the  
10 Commission’s approval of the Preliminary Plan, APS will, with input and assistance from the  
11 collaborative working group, submit a Final Plan for Commission approval.

12 The adjustor will collect DSM costs that are above the \$10 million annual level included in  
13 base rates. The adjustor rate will initially be set at zero, and will be adjusted yearly on March 1,  
14 based upon the account balance and the appropriate kWh or kW charge. The DSM adjustor will  
15 apply to both standard offer and direct access customers.

16 The Settlement Agreement does not provide for the recovery of net lost revenues. The  
17 Settlement Agreement provides that if during 2005 through 2007, APS does not spend at least \$30  
18 million of the base rate allowance for approved and eligible DSM-related items; the unspent amount  
19 will be credited to the account balance for the DSM adjustor.

20 On residential customers’ bills, the DSM adjustor will be combined with the EPS adjustor and  
21 be called an “Environmental Benefits Surcharge.”<sup>27</sup> As part of its tariff compliance filing, within 60  
22 days of this Decision, APS must file a Plan of Administration for Staff review and approval.

23 Pursuant to the Settlement Agreement, APS is required to “implement and maintain a  
24 collaborative DSM working group to solicit and facilitate stakeholder input, advise APS on program  
25

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26 <sup>23</sup> Id. par. 45.

27 <sup>24</sup> Id. par. 42.

<sup>25</sup> Tr. p. 969.

<sup>26</sup> APS’ share of DSM net economic benefits, capped at 10 percent of total DSM expenditures.

28 <sup>27</sup> Settlement Agreement par. 50.

1 implementation, develop future DSM programs, and review DSM program performance.”<sup>28</sup> The  
2 working group will review the plans, but APS is responsible for demonstrating appropriateness of its  
3 programs to the Commission. APS is required to conduct a study to review and evaluate whether  
4 large customers should be allowed to self-direct DSM investments and file the study within one year.  
5 APS is also required to study rate designs that encourage energy efficiency, discourage wasteful and  
6 uneconomic use of energy, and reduce peak demand. The plan for the study and analysis of rate  
7 design modifications must be presented to the collaborative DSM working group within 90 days, and  
8 APS must submit to the Commission the final results as part of its next rate case, or within 15 months  
9 of this Decision, whichever is first. APS is required to develop and propose appropriate rate design  
10 modifications. Additionally, APS is required to file mid-year and end-year reports on each DSM  
11 program.

12 Pursuant to the Settlement Agreement, APS is to invite DSM resources to participate in its  
13 RFP and other competitive solicitations, and must evaluate them in a consistent and comparable  
14 manner.

15 SWEEP supports the DSM provisions in the Settlement Agreement. Although it originally  
16 recommended that the Commission should substantially increase energy efficiency by setting target  
17 goals of 7 percent of total energy resources needed to meet retail load in 2010 from energy efficiency  
18 and 17 percent in 2020, it agreed that the Settlement Agreement’s requirement of DSM funding is  
19 reasonable and justified given the cost-effective benefits that will be achieved. SWEEP believes that  
20 the level of funding in the Settlement Agreement is a valuable and meaningful step towards  
21 encouraging and supporting energy efficiency for APS customers, especially since the Commission  
22 can approve additional DSM program funding through the adjustment mechanism.

23 In response to questioning from Commissioner Spitzer, the witness for SWEEP testified that  
24 DSM is the most efficient way to mitigate market and fuel price increases and it reduces customer  
25 vulnerability to price volatility, by reducing the need for new power plant construction and new  
26 transmission lines.<sup>29</sup> Even customers who do not participate in the DSM programs will benefit, both

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27 <sup>28</sup> Id. par. 54.

28 <sup>29</sup> Tr. p. 877.

1 from an economic perspective as well as from the environmental and health standpoint.<sup>30</sup> The  
2 Preliminary DSM Plan attached as Exhibit B to the Settlement Agreement is a good start towards  
3 developing cost-effective DSM programs. However, there are no demand response programs  
4 included, and given the response by APS customers to last summer's outages as discussed by  
5 Commissioner Hatch-Miller,<sup>31</sup> it is clear that when proper signals are given, customers will respond  
6 by reducing their demand. We believe that it would be beneficial, perhaps in conjunction with the  
7 rate design time-of-use study and the use of "advanced" or "smart" meters, to evaluate and  
8 implement programs designed to reduce APS' summer peak demand. Accordingly, we will  
9 encourage submission of such DSM programs.

10 **i. Environmental Portfolio Standard and other Renewables Programs**

11 The Settlement Agreement addresses renewable energy in three areas: a special renewable  
12 energy solicitation; the environmental portfolio standard ("EPS") and in the competitive procurement  
13 of power.

14 The Settlement Agreement requires APS to issue a special RFP in 2005 seeking at least 100  
15 MW and at least 250,000 MWh per year of renewable energy resources including solar,  
16 biomass/biogas, wind, small hydro (under 10 MW), hydrogen (other than from natural gas) or  
17 geothermal for delivery beginning in 2006. APS also will seek to acquire at least ten percent of its  
18 annual incremental peak capacity needs from renewable resources. Among other requirements, the  
19 renewable resources must be no more costly than 125 percent of the reasonably estimated market  
20 price of conventional resource alternatives and APS can acquire out-of-state resources to meet the  
21 goal if sufficient in-state qualified bids are not received. This special RFP does not displace APS'  
22 requirements under the EPS. APS will continue to collect \$6 million annually in base rates and the  
23 existing EPS surcharge, which provided \$6.5 million during the test year, will be converted to an  
24 adjustment mechanism, which will allow for Commission-approved changes to APS' EPS funding.

25 The Settlement Agreement does not alter the existing EPS or the current level of funding, but  
26 it changes the EPS surcharge into an adjustor so that the Commission has the flexibility to change

27 \_\_\_\_\_  
28 <sup>30</sup> Tr. p. 930.

<sup>31</sup> See discussion Tr. pp. 1384-94.

1 funding levels and rates in the future. APS' current rates and surcharge total \$12.5 million and  
 2 pursuant to the Settlement Agreement, \$6 million of this amount will be recovered in base rates and  
 3 \$6.5 million in the EPS adjustor.

4 Under the Settlement Agreement, APS will allow and encourage all renewable resources to  
 5 participate in its competitive power procurement.

6 In response to a request from Commissioner Spitzer, several parties filed late-filed exhibits  
 7 concerning the recently enacted American Jobs Creation Act of 2004. According to APS, the Act  
 8 provides for a domestic production deduction for its generation activities, and also extends renewable  
 9 electricity production credits through 2005 and expands the types of renewable resources eligible for  
 10 the credits.<sup>32</sup> In its December 10, 2004 response, WRA stated that "renewable energy appears to be  
 11 at a disadvantage relative to gas-fired generation because the tax burden tends to fall more heavily on  
 12 capital intensive projects such as renewable energy generation. Therefore, such tax burden  
 13 differentials may add further support for the preference for renewable energy in the settlement  
 14 agreement and for production tax credits as means to 'level the playing field' between gas-fired  
 15 resources and renewable energy."

16 **j. Competitive Procurement of Power**

17 The Settlement Agreement provides that APS will issue an RFP or other competitive  
 18 solicitation(s) in 2005 seeking long-term resources of not less than 1000 MW for 2007 and beyond.  
 19 "Long-term" resource is defined as acquisition of a generating facility or an interest in one, or any  
 20 PPA of 5 years or longer. No APS affiliate will participate in this RFP/solicitation, and in the future  
 21 will not participate unless an independent monitor is appointed. Further, APS will not self-build any  
 22 facility with an in-service date prior to January 1, 2015, unless expressly authorized by the  
 23 Commission. "Self-build" does not include the acquisition of a generating unit or interest in one  
 24 from a non-affiliated merchant or utility generator, the acquisition of temporary generation needed  
 25 for system reliability, distributed generation of less than 50 MW per location, renewable resources, or  
 26 the up-rating of APS generation. APS will continue to use its Secondary Procurement Protocol

27 \_\_\_\_\_  
 28 <sup>32</sup> Previously, only wind, closed-loop biomass and poultry waste were included, and now open-loop biomass, geothermal  
 energy, solar energy, small irrigation power, and municipal solid waste are included as qualified energy resources.

1 except as modified by the Settlement Agreement or by Commission decision. The Commission's  
2 Staff will schedule workshops on resource planning, focusing on developing needed infrastructure  
3 and a flexible, timely, and fair competitive procurement process.

4 **k. Regulatory Issues**

5 In the Settlement Agreement, the parties acknowledge that APS has the obligation to plan for  
6 and serve all customers in its certificated service area and to recognize through its planning, the  
7 existence of any Commission direct access program and the potential for future direct access  
8 customers. Any change in retail access as well as the resale by APS and other Affected Utilities of  
9 Revenue Cycle Services to ESPs will be addressed through the Electric Competition Advisory Group  
10 ("ECAG") or similar process. The parties acknowledge that APS may join a FERC-approved  
11 Regional Transmission Organization ("RTO") or entity and may participate in those activities  
12 without further order or authorization from the Commission.

13 **l. Competition Rules Compliance Charge ("CRCC")**

14 Included in the total test year revenue requirement is approximately \$8 million for the  
15 Competition Rules Compliance Charge. APS will recover \$47.7 million plus interest through a  
16 CRCC of \$0.000338/kWh over a collection period of 5 years. When that amount is collected, the  
17 CRCC will immediately terminate, and if the amount is under or over recovered, then APS must file  
18 an application for the appropriate remedy.

19 **m. Low Income Programs**

20 APS will increase funding for marketing its E-3 and E-4 tariffs to a total of \$150,000 as set  
21 forth in the Settlement Agreement. The parties' intent is to insulate eligible low income customers  
22 from the effects of the rate increase resulting from the Settlement Agreement. On December 17,  
23 2004, the ACAA filed a response to Commissioner Mayes' question about automatic enrollment in  
24 utility discount programs, indicating that they have initiated a discussion with the Arizona  
25 Department of Economic Security ("DES") to facilitate the automatic enrollment in utility discount  
26 programs, as well as other agency managed programs. ACAA is in the process of adding the utility  
27 discount application forms to its website, which will allow the form to be sent electronically to the  
28 appropriate entity for processing. Concerning marketing efforts, ACAA stated that it engages in

1 various outreach efforts throughout the state, providing information about the E-3 discount program  
2 available through APS. ACAA indicated that DES is currently charged with the official marketing of  
3 the program, but there is currently no affirmative marketing of the program “as their resources are  
4 severely limited.” Also in response to Commissioner Mayes’ request, APS filed information  
5 concerning its low income programs. APS stated that it has renewed its conversations with DES and  
6 ACAA, requesting feedback on increasing participation through automated signup for the E-3 and E-  
7 4 programs. Both agencies expressed interest and APS states that it will continue to work with both  
8 agencies to determine the efficiency and practicality of such a streamlined approach.

9 **n. Returning Customer Direct Access Charge (“RCDAC”)**

10 The Settlement Agreement provides that APS can recover from Direct Access customers the  
11 additional cost that would otherwise be imposed on other Standard Offer customers if and when the  
12 former return to Standard Offer from their competitive suppliers. The RCDAC shall not last longer  
13 than 12 months for any individual customer. The charge will apply only to individual customers or  
14 aggregated groups of 3 MW or greater who do not provide APS with one year’s advance notice of  
15 intent to return to Standard Offer service. APS will file a Plan of Administration as part of its tariff  
16 compliance filing.

17 **o. Service Schedule Changes**

18 The Settlement Agreement adopts several of APS’ proposed changes to service schedules,  
19 including Schedule 3, but with the retention of the 1,000 foot construction allowance for individual  
20 residential customers and also with any individual residential advances of costs being refundable.  
21 Several APS customers made public comment about the line extension policy and how it has not been  
22 modified in a long time. We will direct Staff to work with APS to review its line extension policy  
23 and determine whether the construction allowance should be modified.

24 **p. Nuclear Decommissioning**

25 The decommissioning costs as recommended by APS are adopted as set forth in Appendix I to  
26 the Settlement Agreement.

27 **q. Transmission Cost Adjustor (“TCA”)**

28 The Settlement Agreement establishes a transmission cost adjustor (“TCA”) to ensure that

1 any potential direct access customers pay the same for transmission as Standard Offer customers.  
 2 The TCA is limited to recovery of costs associated with changes in APS' open access transmission  
 3 tariff ("OATT") or equivalent tariff. The TCA goes into effect when the transmission component of  
 4 retail rates exceeds the test year base amount of \$0.00476<sup>33</sup> per kWh by 5 percent and APS obtains  
 5 Commission approval of a TCA rate.

6 **r. Distributed Generation**

7 Generally, distributed generation is small-scale power generation units strategically located  
 8 near customers and load centers. According to the ACA/DEAA, the benefits of distributed energy  
 9 systems include: greater grid reliability; increased grid stability (voltage support along transmission  
 10 lines); increased system efficiency (reduction in transmission line losses); increased efficiency;  
 11 flexibility; decreased pressure on natural gas (demand and cost); leverage of resources; and  
 12 sustainable installations.

13 The Settlement Agreement provides that Staff shall schedule workshops to consider  
 14 outstanding issues affecting distributed generation and shall refer to the results of the prior distributed  
 15 generation workshops for issues to study.

16 ACA/DEAA presented its objectives at hearing as follows: a DG workshop with strong Staff  
 17 leadership; clear goals, ground rules, milestones, and deadlines; participants with authority;  
 18 continuing reports to ACC and management; and a process to bring contested issues to the  
 19 Commission for resolution. None of the proponents of the Settlement Agreement oppose  
 20 Commission adoption of these objectives.

21 In its post-hearing brief, ACA/DEAA listed the following guidelines as "overriding criteria":  
 22 1) rates must be fair; 2) rates should be designed to send as efficient as possible pricing signals to  
 23 consumers; 3) impediments to customer choices, such as unnecessarily difficult and expensive  
 24 interconnection to the grid, should be eliminated to the maximum extent possible; 4) all generators  
 25 should be treated fairly – large and small; and 5) proposals, if implemented, should not interfere with  
 26 the Commission's public policy goals. ACA/DEAA made 3 recommendations: 1) Rate Design – the

27 \_\_\_\_\_  
 28 <sup>33</sup> Paragraph 106 of the Settlement Agreement contains a typo; the amount "\$0.000476" should actually be "\$0.00476,"  
 Tr. p. 1168.

1 Commission should adopt an experimental rate for partial requirement customers. The proposal  
2 would mimic SRP's E-32 rate, which includes time of day rates and summer/winter rates.  
3 ACA/DEAA proposed to limit participation to 50 MWs of new customer load each year for 5 years –  
4 both generation and supplemental load. It appears that this is the first alternative rate schedule that  
5 ACA/DEAA has proposed, and no party has had an opportunity to evaluate and comment on the  
6 proposal. Accordingly, we decline to adopt the proposal in this docket, but we believe that this  
7 proposal may be a good starting point for discussion in the DG workshop.

8 ACA/DEAA further recommended that the Texas standard is best suited for application to the  
9 APS system and that the provisions of California rule 21 would serve as a second choice for DG  
10 standards in Arizona. ACA/DEAA also recommended that the Commission consider a program to  
11 install self generation to reduce the electricity on the power grid. We believe that both of these  
12 recommendations should also be discussed and developed during the course of the workshop.

13 The proponents of the Settlement Agreement recommend that specific issues concerning DG  
14 should be addressed in workshops devoted to distributed generation. Paragraphs 108 and 109 direct  
15 Staff to schedule workshops to address outstanding DG issues. They believe that such a process  
16 would use the work done in previous workshops and would also address the technical aspects of  
17 connecting distributed generation in a way that would apply to all regulated utilities in Arizona. To  
18 be successful, the process would require a strict timetable for producing recommendations for the  
19 Commission's consideration. The proponents argue that Schedule E-32 should not be redesigned to  
20 meet the specialized needs of partial requirements service, but that the rate design for partial  
21 requirements service should be addressed in the workshop. Approximately 95,000 full requirement  
22 customers receive service under Schedule E-32, and according to the proponents, it is an integral part  
23 of the Settlement Agreement. The proponents believe that ACA/DEAA's proposal to put the rate  
24 increase in the energy portion would create a massive subsidy from higher load factor customers to  
25 lower load factor customers. The demand related charges are necessary for pricing the capacity  
26 related costs of the APS system for the full requirement customers. The proponents argue that DG  
27 requires partial requirement service – which is a very specialized product that includes maintenance  
28 power, standby power, and supplemental power – and it should have its own rate, which can be

1 addressed in the proposed DG workshop.

2 We agree with ACA/DEAA that DG can have significant benefits to APS and to its ratepayers  
3 and we want to encourage the growth of DG that can provide those benefits. However, we also agree  
4 with the proponents that schedule E-32 should not be modified to accommodate the particular needs  
5 associated with DG. We believe that the parties should address the issue of an appropriate rate  
6 schedule for DG during the workshop process, and direct the parties to develop a schedule that is  
7 designed particularly for DG customers.

8 s. **Bark Beetle Remediation**

9 APS is authorized to defer for later recovery the reasonable and prudent direct costs of bark  
10 beetle remediation that exceed the test year levels of tree and brush control. In the next rate case, the  
11 Commission will determine the reasonableness, prudence, and allocation of the costs, and will  
12 determine the appropriate amortization period.

13 t. **Rate Design**

14 Attached to the Settlement Agreement is Appendix J, which sets forth the rates adopted in the  
15 Settlement Agreement. The rates are designed to permit APS to recover an additional \$67.5 million  
16 in base revenues, including an additional 3.94 percent for the residential rate class and a 3.57 percent  
17 increase for the general service rate class. The rates were designed to move toward costs and remove  
18 subsidizations, thereby promoting equity among customers. The base rates will also permit cost-  
19 based unbundling of distribution and revenue cycle services, including metering, and meter reading  
20 and billing. The parties believe that this will give appropriate price signals necessary for shopping.  
21 APS will continue on-peak and off-peak rates for winter billing for all residential time-of-use  
22 customers under Schedules ET-1 and ECT-1R. Within 180 days APS will submit a study to Staff  
23 that examines ways APS can implement more flexibility in changing APS' on- and off-peak time  
24 periods and other time-of-use characteristics, making those periods more reflective of actual system  
25 peak time periods. The Settlement Agreement adopts APS' proposed experimental time-of-use  
26 periods for ET-1 and ECT-1R. For general service customers, the existing on-peak time periods will  
27 remain the same and the summer rate period will begin in May and conclude in October. The general  
28 service rate schedules will also permit cost-based unbundling of generation and revenue cycle

1 services and will be differentiated by voltage levels. An additional primary service discount of  
2 \$2.74/kW for military base customers served directly from APS substations will be adopted. The  
3 Settlement Agreement modifies Schedule E-32 in order to simplify the design, make it more cost-  
4 based, and to smooth out the rate impact across customers of varying sizes within the rate schedule.  
5 Changes include the addition of an energy block for customers with loads under 20 kW and an  
6 additional demand billing block for customers with loads greater than 100 kW. A time-of-use option  
7 will also be available to E-32 customers. As discussed above, ACA/DEAA objected to the  
8 company's E-32 schedule. One of ACA/DEAA's concern was the almost doubling of the demand  
9 charge. The Commission has open dockets involving APS' metering and bill estimation procedures,  
10 including the estimation of demand. Although we are not resolving those issues in this rate case, we  
11 are concerned that APS properly meter, read meters and bill its customers timely and accurately.<sup>34</sup> It  
12 is imperative, especially given the increase in the demand charge, that APS reduce the instances  
13 where it estimates demand.

14 Several schedules are "frozen" and APS will provide notice approved by Staff to those  
15 customers that those rates will be eliminated in APS' next rate case. Such notice will be provided at  
16 the conclusion of this docket and at the time that APS files its next rate case.

17 **u. Litigation and other issues**

18 The Settlement Agreement provides that APS will dismiss with prejudice all appeals of  
19 Decision No. 65154, the Track A Order, and APS and its affiliates will dismiss litigation related to  
20 Decision Nos. 65154 and 61973 and/or any alleged breach of contract, and APS and its affiliates shall  
21 forgo any claim that APS, PWEC, Pinnacle West Capital Corporation or any of APS' affiliates were  
22 harmed by Decision No. 65154, and the Preliminary Inquiry ordered in Decision No. 65796 shall be  
23 concluded with no further action by the Commission, once the Settlement Agreement is approved in  
24 accordance with Section XXI of the Settlement Agreement by a Commission Decision that is final  
25 and no longer subject to judicial review.

---

26 <sup>34</sup> Also, we note that apparently APS is deleting a bill estimation procedure for EC-1 and ECT-1R. It is not clear whether  
27 these are the tariffs that Staff has alleged APS has not been following, but nothing in this Decision will affect our ability  
28 to make findings in Docket Nos. E01345A-04-0657, et al. or impose any appropriate fines, sanctions, or remedies in  
those dockets.

1 **v. Summary**

2 This Settlement Agreement resolves numerous significant, complex, and conflicting issues  
 3 affecting many parties with very different perspectives and interests. As with every settlement, the  
 4 give and take nature of negotiations ends up with a product that no one party initially proposed. The  
 5 key question when deciding whether to approve such a settlement is whether the end result resolves  
 6 the important issues fairly and reasonably when taken together as a whole, and in such a way that will  
 7 promote the public interest. We believe that the Settlement Agreement reached by these 22 parties,  
 8 with the modifications that we make herein, reaches such a result. Our agreement to rate base the  
 9 PWEC assets does not mean that we are retreating from our commitment to encourage the  
 10 development of competition, and we expect APS and its affiliates to fully comply with all the pro-  
 11 competition requirements in the Settlement Agreement and other Commission decisions and rules.  
 12 Additionally, our adoption of a PSA will be a significant change for APS customers, and we expect  
 13 APS to educate and inform its customers about all aspects of that adjustor charge in a way that will  
 14 minimize confusion and misunderstandings. Finally, we want to make it clear to APS that our  
 15 adoption of a PSA does not relieve it of its obligation to effectively and efficiently manage its fuel  
 16 costs, and that we will closely monitor APS' performance.

17 \* \* \* \* \*

18 Having considered the entire record herein and being fully advised in the premises, the  
 19 Commission finds, concludes, and orders that:

20 **IV. FINDINGS OF FACT**

21 1. APS is a public service corporation principally engaged in furnishing electricity in the  
 22 State of Arizona. APS provides either retail or wholesale electric service to substantially all of  
 23 Arizona, with the major exceptions of the Tucson metropolitan area and about one-half of the  
 24 Phoenix metropolitan area. APS also generates, sells and delivers electricity to wholesale customers  
 25 in the western United States.

26 2. On June 27, 2003, APS filed with the Commission an application for a \$175.1 million  
 27 rate increase and for approval of a purchased power contract.

28 3. Notice of the application was provided in accordance with the law.

1           4.       Intervention was granted to AECC, FEA, Kroger, RUCO, AUIA, Phelps Dodge,  
2 IBEW, ACA/DEAA, Panda, AWC, SWG, WRA, CNE, SEL, DVEP, UES, ACAA, Alliance,  
3 Wickenburg, AriSEIA, AARP, SWEEP, PPL Sundance, PPL Southwest, SWPG, Mesquite, and  
4 Bowie.

5           5.       By Procedural Order issued August 15, 2003, the hearing was set to commence on  
6 April 7, 2004, and procedural dates were established for the filing of testimony and evidence.

7           6.       On February 6, 2004, APS filed a Motion to Amend the Rate Case Procedural  
8 Schedule, and a procedural conference was held on February 18, 2004 to discuss the Motion.

9           7.       By Amended Rate Case Procedural Order issued on February 20, 2004, the hearing  
10 date was rescheduled for May 25, 2004 and other procedural dates were modified.

11          8.       On April 6, 2004, Staff filed a Motion to Amend the Procedural Schedule and on April  
12 8, 2004, Staff filed a Memorandum indicating that representatives of APS had contacted Staff about  
13 the possibility of conducting settlement negotiations.

14          9.       A public comment hearing was held on April 7, 2004.

15          10.      On April 13, 2004, APS filed its Response to Staff's Motion and Staff Notice of  
16 Settlement Negotiations and requested a temporary suspension of the procedural schedule in order for  
17 settlement discussions to take place.

18          11.      Pursuant to Procedural Orders issued April 7 and 12, 2004, a procedural conference to  
19 discuss Staff's Motion was held on April 15, 2004. By Procedural Order issued April 16, 2004, new  
20 procedural dates were established and another procedural conference was scheduled for April 28,  
21 2004.

22          12.      The April 28, 2004 procedural conference was held as scheduled and by Procedural  
23 Order issued April 29, 2004, the procedural schedule was stayed and another procedural conference  
24 was scheduled for May 26, 2004.

25          13.      Pursuant to procedural conferences held on May 26 and June 14, 2004, and Procedural  
26 Orders issued on May 26, June 18, and July 20, 2004, the stay was extended in order to allow the  
27 parties to discuss settlement.

28          14.      At the August 18, 2004 Procedural Conference, the parties announced that they had

1 reached a settlement, and the Settlement Agreement was docketed on that date.

2 15. On August 20, 2004, an Amended Rate Case Procedural Order was issued setting the  
3 hearing on the Settlement Agreement to commence on November 8, 2004.

4 16. The hearing was held as scheduled on November 8, 9, 10, 29, 30 and December 1, 2,  
5 and 3, 2004. Public comment was taken and testimony from the proponents of the Settlement  
6 Agreement was presented in panel format, and testimony from the ACA/DEAA was also presented in  
7 a panel format.

8 17. The Test Year ending 2002 Plant in Service was \$4,876,901,000, excluding  
9 transmission plant, and including the PWEC assets as of December 31, 2004.

10 18. APS' FVRB is \$5,054,426,000 and a 5.92 fair value rate of return is appropriate.

11 19. It is just and reasonable to authorize a total annual revenue increase in the amount of  
12 \$75,500,000, consisting of an increase in base rates of approximately 3.77 percent or \$67.6 million,  
13 and an increase in the CRCC surcharge of approximately .44 percent, which will collect \$7.9 million.

14 20. A Power Supply Adjustor as set forth in the Settlement Agreement and as modified  
15 herein, is in the public interest.

16 21. APS is authorized to acquire the PWEC generation assets and rate base those assets at  
17 a value of \$700 million as of December 31, 2004, under the terms and conditions as set forth in the  
18 Settlement Agreement and herein.

19 22. The Settlement Agreement will allow APS the opportunity to earn a reasonable rate of  
20 return on its investment, will provide revenues sufficient for the Company to provide efficient and  
21 reliable service, and will allow for continued development of electric competition in Arizona.

22 23. APS shall implement a customer education program explaining how its PSA will work  
23 and shall maintain on its website information explaining the billing format, rates, and charges,  
24 including up-to-date information about the PSA and current gas costs.

25 24. APS shall submit its Plan of Administration for the PSA for Commission approval  
26 within 60 days of the effective date of this Decision.

27 25. The depreciation rates and the costs for nuclear decommissioning as set forth in the  
28 Settlement Agreement are reasonable and appropriate.

**V. CONCLUSIONS OF LAW**

1  
2 1. Arizona Public Service Company is a public service corporation within the meaning of  
3 Article XV of the Arizona Constitution and A.R.S. §§ 40-222, 250, 251, and 376.

4 2. The Commission has jurisdiction over Arizona Public Service Company and the  
5 subject matter of the application.

6 3. Notice of the application was provided in accordance with the law.

7 4. The Settlement Agreement, with the modifications and additional provisions contained  
8 herein, resolves all matters raised by APS' rate application in a manner that is just and reasonable,  
9 and promotes the public interest.

10 5. The fair value of APS' rate base is \$5,054,426,000, and 5.92 percent is a reasonable  
11 rate of return on APS' rate base.

12 6. The rates, charges, and conditions of service established herein are just and  
13 reasonable.

14 7. APS should be directed to file revised tariffs consistent with the Settlement Agreement  
15 and the findings contained in this Order.

**VI. ORDER**

16  
17 IT IS THEREFORE ORDERED that the Settlement Agreement attached hereto as  
18 Attachment A as modified herein is approved.

19 IT IS FURTHER ORDERED that Arizona Public Service Company is hereby directed to file  
20 with the Commission on or before March 31, 2005, revised schedules of rates and charges consistent  
21 with Exhibit A and the findings herein.

22 IT IS FURTHER ORDERED that the revised schedules of rates and charges shall be effective  
23 for all service rendered on and after April 1, 2005.

24 IT IS FURTHER ORDERED that Arizona Public Service Company shall notify its affected  
25 customers of the revised schedules of rates and charges authorized herein by means of an insert in its  
26 next regularly scheduled billing and by posting on its website, in a form approved by the  
27 Commission's Utilities Division Staff.

28 IT IS FURTHER ORDERED that Arizona Public Service Company shall implement a

1 customer education program explaining how its PSA will work and shall maintain on its website  
2 information explaining the billing format, rates, and charges, including up-to-date information about  
3 the PSA and current gas costs.

4 IT IS FURTHER ORDERED that Arizona Public Service Company shall implement and  
5 comply with the terms of the Settlement Agreement including filing all reports, studies, and plans as  
6 set forth in the Settlement Agreement and as modified herein.

7 IT IS FURTHER ORDERED that Arizona Public Service Company shall submit its Plan of  
8 Administration for the PSA for Commission approval within 60 days of the effective date of this  
9 Decision.

10 IT IS FURTHER ORDERED that Arizona Public Service Company shall forgo any present or  
11 future claims of stranded costs associated with any of the PWEC assets.

12 IT IS FURTHER ORDERED that the Commission's Utilities Division Staff shall schedule  
13 workshops on resource planning issues and distributed generation issues within 90 days of the  
14 effective date of this Decision.

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IT IS FURTHER ORDERED that the Commission’s Utilities Division Staff shall initiate a rulemaking proceeding to modify A.A.C. R14-2-1618 within 120 days of the effective date of this Decision.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER COMMISSIONER

CHAIRMAN COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this \_\_\_\_ day of \_\_\_\_\_, 2005.

\_\_\_\_\_  
BRIAN C. McNEIL  
EXECUTIVE SECRETARY

DISSENT \_\_\_\_\_

DISSENT \_\_\_\_\_

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