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BEFORE THE ARIZONA CORPORATION COMMISSION

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Commissioner
MIKE GLEASON
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KRISTIN K. MAYES
Commissioner

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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND FOR APPROVAL OF PURCHASED POWER CONTRACT.

DOCKET NO. E-01345A-03-0437
NOTICE OF FILING REBUTTAL TESTIMONY OF KEVIN C. HIGGINS

Arizonans for Electric Choice & Competition hereby provides notice of filing the rebuttal testimony of its witness, Kevin C. Higgins, in the above-captioned docket.

RESPECTFULLY SUBMITTED this 30th day March, 2004.

FENNEMORE CRAIG, P.C.

Arizona Corporation Commission

DOCKETED

MAR 30 2004

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REBUTTAL TESTIMONY OF KEVIN C. HIGGINS

On Behalf of Arizonans for Electric Choice & Competition

Docket No. E-01345A-03-0437

March 30, 2004

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1 **REBUTTAL TESTIMONY OF KEVIN C. HIGGINS**

2

3 **Introduction**

4 **Q. Please state your name and business address.**

5 A. Kevin C. Higgins, 39 Market Street, Suite 200, Salt Lake City, Utah,
6 84101.

7 **Q. By whom are you employed and in what capacity?**

8 A. I am a Principal in the firm of Energy Strategies, LLC.

9 **Q. On whose behalf are you testifying in this proceeding?**

10 A. My testimony is being sponsored by Arizonans for Electric Choice and
11 Competition (“AECC”).

12 **Q. Are you the same Kevin C. Higgins who has previously filed direct testimony**
13 **in this case?**

14 A. Yes, I am.

15 **Q. What recommendations do you make in your rebuttal testimony?**

16 A. My rebuttal testimony supports the following recommendations:

17 (1) I recommend that the Commission reject RUCO witnesses Marylee Diaz
18 Cortez’s and Richard A. Rosen’s proposals to eliminate the right to direct access
19 service, as well as Ms. Diaz Cortez’s recommendation that the Commission find
20 the 1999 Settlement Agreement “expired” and “void”;

21 (2) I recommend that the Commission reject RUCO’s proposal to raise rates by
22 \$35 million to fund Demand-Side Management (“DSM”) programs;

1 (3) I offer an alternative rate design to the Environmental Portfolio Surcharge
2 proposed by Staff witness Barbara Keene; however, I note that Ms. Keene's
3 proposal retains important aspects of the balance of interests contained in the
4 design of the current surcharge. Therefore, if my preferred option of a strictly
5 proportional increase is not adopted, then I support approval of Ms. Keene's rate
6 design for the Environmental Portfolio Surcharge;

7 (4) I support APS' use of the 4-CP method for allocating fixed production costs
8 and recommend against adoption of alternatives to that method. I also recommend
9 against allocating a portion of distribution system costs based on energy, as
10 proposed by RUCO witness John Stutz.

11 **Direct Access and the 1999 Settlement Agreement**

12 **Q. What does Ms. Diaz Cortez recommend with respect to direct access and the**
13 **1999 Settlement Agreement?**

14 A. Testifying on behalf of RUCO, Ms. Diaz Cortez recommends that the
15 Commission eliminate the right to direct access service for all APS customers.
16 She further recommends that the Commission declare the 1999 Settlement
17 Agreement "expired" and "voided."¹

18 **Q. What is your assessment of Ms. Diaz Cortez's proposal?**

19 A. Ms. Diaz Cortez's proposal should be rejected. Retail access is an issue of
20 statewide importance. The Commission has already established a process for
21 evaluating the Electric Competition Rules. Ms. Diaz Cortez is attempting to
22 circumvent that process by forcing the issue of retail access into this rate case.

¹ Pre-filed direct testimony of Marylee Diaz Cortez, p. 9, lines 6-15.

1 This rate case has important issues of its own to be decided and is not the right
2 venue for addressing the totality of the Electric Competition Rules.

3 Moreover, in her discussion of the 1999 Settlement Agreement, Ms. Diaz
4 Cortez grossly mischaracterizes the benefits of the bargain that was struck under
5 the settlement. Her testimony on this point is nothing short of disingenuous. Her
6 proposal to eliminate direct access rights for *all APS customers* demonstrates bad
7 faith toward AECC, which was a partner with RUCO in negotiating the settlement
8 with APS.

9 **Q. Did you help negotiate the 1999 Settlement Agreement?**

10 A. Yes, I did, on behalf of AECC.

11 **Q. Did Ms. Diaz Cortez ever participate in those negotiations?**

12 A. No.

13 **Q Please explain your view that Ms. Diaz Cortez grossly mischaracterizes the**
14 **benefits of the bargain that was struck under the settlement.**

15 A. The overriding objective of the 1999 Settlement Agreement was to remove
16 the obstacles to implementing the Commission's Electric Competition Rules. This
17 is what AECC sought to achieve, while building in features that protected
18 customers against uncertainty and provided tangible savings in the form of
19 regularly-scheduled Standard Offer rate reductions. The Electric Competition
20 Rules, while certainly subject to continued Commission jurisdiction, were not
21 fashioned as a "pilot project" or an "experiment." The fundamental premise was
22 the establishment of a permanent right for customers to shop for power if they so

1 chose. This is a long-run proposition, and AECC negotiated with the long view in
2 mind.

3 **Q. What is an example of taking the long-view in the 1999 Settlement**
4 **Agreement?**

5 A. The agreement provided for stranded cost payments to be paid by
6 shopping customers to APS during a transition period that stretched from 1999
7 through 2004. Stranded cost payments are an impediment to shopping, but were
8 part of the package in the Electric Competition Rules, and therefore a necessary
9 part of the solution. AECC agreed to six years of stranded cost charges, starting in
10 1999, in the belief that it was best for Arizona customers to address this legal
11 obligation head on, agree to a stipulated level of obligation, and retire it once and
12 for all. With stranded cost charges scheduled (initially) to be retired at the end of
13 2004², customers seeking to shop could one day expect to enjoy a more level
14 playing field. Now – before stranded cost charges are even ended – RUCO seeks
15 to have the Settlement Agreement declared “expired” and have the Commission
16 wipe out the primary benefit of AECC’s bargain: the right to shop for power.

17 **Q. What is another example of taking the long view in the Settlement**
18 **Agreement?**

19 A. The parties to the Settlement Agreement did not propose to establish any
20 shopping credit subsidies to assist the retail competitive market in getting started.
21 While it may have been tempting to support the initiation of retail access in such a
22 manner, my view was that one of the major problems facing Arizona ratepayers in

² In this proceeding, APS has proposed to move up the date of ending its stranded cost charge (or CTC) to June 30, 2004.

1 1999 was a staggering burden of deferred costs. Hundreds of millions of dollars
2 worth of APS expenses since the 1980s had been deferred and booked as
3 regulatory assets. Paying off this gigantic debt has been costing APS customers
4 around \$120 million per year, a burden that will not be paid off until June 30,
5 2004. Understandably, AECC did not advocate for any implementation approach
6 that would have subsidized retail access and added to APS' regulatory assets. This
7 was another example of taking the long view.

8 **Q. In what way is Ms. Diaz Cortez's testimony on the Settlement Agreement**
9 **disingenuous?**

10 A. On page 17 of her direct testimony, Ms. Diaz Cortez testifies that voiding
11 the 1999 Settlement Agreement and eliminating the right to shop will not result in
12 the non-performance of any of the agreement's terms. She justifies this conclusion
13 by stating that "the distribution system was opened to direct access per section 1.1
14 of the agreement."³ It is disingenuous to assert that *closing* the distribution
15 system now to direct access would not result in non-performance under the
16 agreement, on the grounds that the distribution system had been opened for a
17 limited period of time. Direct access was not established merely for a four-year
18 window. Confiscating the right to shop from customers would rob AECC of the
19 primary benefit of its bargain from the 1999 Settlement Agreement and would
20 clearly result in non-performance under the agreement. Ms. Diaz Cortez's cavalier

³ Pre-filed direct testimony of Marylee Diaz Cortez, p. 17, line 21 – p. 18, line 14.

1 declaration that “no party will be left unwhole by the expiration of the
2 agreement”⁴ is simply false.

3 **Q. Has having the right to shop been harmful to Arizona customers?**

4 A. No. Arizona designed its direct access program in a manner that protected
5 customers from the severe market volatility experienced in the West in 2000 and
6 2001. While this volatility negatively impacted customers’ *exercise* of their right
7 to shop, the mere *possession* of the right has not been a problem. Direct access
8 has taken hold in other parts of the country when the underlying economics have
9 been supportive.⁵ Arizona customers who wish to exercise their right to shop in
10 the future should not be deprived of that opportunity. Given the extreme difficulty
11 in securing this right, it would be rash and unnecessary to take it away.

12 **Q. What about Ms. Diaz Cortez’s assertion that residential customers are
13 unlikely to benefit from retail access?**

14 A. I agree that residential customers are not main focus of Electric Service
15 Providers (ESPs), although residential aggregation programs have been successful
16 in places such as Ohio. It was in recognition that residential customers would be
17 less likely to participate in direct access service that the Settlement Agreement
18 provided a larger cumulative Standard Offer rate reduction for residential
19 customers than for large customers, 7.5 percent versus 5.0 percent. But even if
20 residential customers are less likely to take direct access service than a
21 commercial or industrial customer, it does not warrant taking this option away
22 from residential customers.

⁴ Ibid., p. 18, lines 20-21.

1 **Q. In the event that the Commission decides to act on RUCO's proposal, what**
2 **do you recommend?**

3 A. In such event, any rollback of the right to shop should be limited to
4 residential customers. In association with such a limitation, the Commission could
5 also eliminate any residential customer responsibility for forward-going costs
6 associated with direct access service. This should satisfy RUCO.

7 But there is no reason to deny *non-residential* customers the right to shop.
8 Non-residential customers are not asking the Commission to have this right taken
9 away from them.

10 **Q. What about small commercial customers? Should their right to shop be**
11 **taken away?**

12 A. Absolutely not. Based on my experience in other parts of the country,
13 smaller commercial customers often have some of the best opportunities for
14 savings from direct access.

15 **Q. What about Dr. Rosen's recommendation to eliminate the right to shop in**
16 **order to minimize the degree of FERC's authority over transmission in**
17 **Arizona?**

18 A. From a customer perspective, there are two principal issues to address
19 concerning federal jurisdiction. The first is the reasonableness of transmission
20 rates based on cost-of-service regulation. This is unlikely to be a problem for
21 customers. Transmission service is a relatively small portion of customers' bills,
22 and there is little reason to expect a material difference in electric power rates to

⁵ Texas, Illinois, Michigan, Ohio, Maine, Massachusetts, and New York are some examples of states with significant direct access activity.

1 customers that would result from FERC-determined versus state-determined
2 transmission rates.

3 The second principal issue is the assurance of an economic priority to the
4 use of that part of the transmission system built to deliver power to native load
5 customers – both bundled and direct access customers. Dr. Rosen raises the fear
6 of losing priority, through FERC usurpation, as one of the main reasons to
7 abandon direct access.⁶

8 I agree with Dr. Rosen that retaining transmission priority for native load
9 customers is an important objective. To that end, I spent years – and hundreds of
10 hours – negotiating with other RTO stakeholders the terms of the “congestion
11 management” protocol that the southwestern utilities, including APS, filed with
12 FERC. That protocol is contained in Appendix A of the WestConnect tariff.
13 Through the terms of its allocation of Firm Transmission Rights (“FTR”) auction
14 proceeds and its “tiebreaking” provisions, Appendix A ensures an economic and
15 reliability priority for native load customers. This protocol was painstakingly put
16 together to protect native load customers and to ensure non-discriminatory
17 treatment between bundled and direct access customers. It has already been
18 approved by FERC. Dr. Rosen’s apparent belief that it is necessary to take the
19 drastic step of abrogating direct access rights in order to ensure native load
20 transmission priority is misplaced. The hard work to establish such assurance has
21 already been performed. His recommendation to sweep away direct access rights

⁶ Pre-filed direct testimony of Richard A. Rosen, p. 11, lines 7-17.

1 in order to address a concern that has been thoroughly addressed elsewhere should
2 be rejected.

3 **Demand Side Management**

4 **Q. What is your assessment of RUCO's proposal to raise rates \$35 million to**
5 **fund Demand-Side Management (DSM) programs?**

6 A. I recommend against adoption of this proposal, which is presented in the
7 direct testimony of Ms. Diaz Cortez.⁷ RUCO's proposal would raise rates an
8 average of 2 percent by imposing a 1.5 mill per-kwh DSM charge. While energy
9 conservation and load management have value, the program proposed by RUCO
10 would have a significant rate impact and is likely to exacerbate the substantial
11 cross-subsidies between rate classes that are already present in APS' rates.

12 The first step in sending the right message for energy conservation is to
13 remove the cross-subsidies in rates that mask energy price signals. A far more
14 reasonable approach to DSM is contained in Staff's overall rate proposal, which
15 combines a significant and appropriate movement toward cost-of-service rates⁸
16 with a more modest DSM rate impact of \$4 million.⁹ If a DSM program is
17 mandated, it should be based on Staff's overall approach, not RUCO's.

18 **Q. Do you have any other concerns regarding RUCO's DSM proposal?**

19 A. Yes. Given that the residential advocate is championing this significant
20 cost increase, to the extent that the Commission wishes to pursue it, consideration

⁷ Pre-filed direct testimony of Marylee Diaz Cortez, p. 27, line 4 – p. 29, line 2.

⁸ Pre-filed direct testimony of Erinn A. Andreason, p. 4, line 16 – p. 5, line 10.

⁹ Pre-filed direct testimony of Barbara Keene, p. 10, lines 4-6.

1 should be given to limiting program funding and participation to residential
2 customers.

3 If, to the contrary, funding requirements are imposed on non-residential
4 customers, then customers whose cumulative charges reach a reasonable critical
5 mass should have the ability to self-direct any DSM funds that are collected; that
6 is, if non-residential customers are required to pay a DSM charge, then those
7 funds should accrue in an account in that customer's name, and the customer
8 should be able to use the funds for DSM purposes in its own facilities. A
9 reasonable threshold for self-direction would be any customer with a multi-site
10 aggregated use of 4 million kwh per year, which is equivalent to an average
11 demand of approximately 450 kw. Such a customer would pay \$6000 per year in
12 DSM charges under RUCO's proposal. If this level of funding is to be collected
13 from individual customers, they should be allowed to direct it to investments in
14 their own facilities, rather than having it spent on somebody else's.

15 **Q. Do you have any comments on the rate design for DSM?**

16 A. Yes. The flat 1.5 mills-per-kwh charge proposed by RUCO would place
17 an unfair cost burden on high-load-factor customers, whose energy usage does not
18 fluctuate significantly relative to their peaks, and who, on the average, cost less to
19 serve because they make efficient use of utility assets. If a DSM charge is
20 adopted, alternative rate designs, such as percentage of bill, or demand charges
21 for customers with necessary meters, should be considered.

1 **Environmental Portfolio Standard**

2 **Q. Do you have any comments on Staff's recommendation for funding the**
3 **Environmental Portfolio Standard ("EPS")?**

4 A. Yes. Staff witness Barbara Keene proposes changes to the Environmental
5 Portfolio Surcharge that would raise an additional \$4.4 million in funding for
6 EPS-related projects. This is about a 67 percent increase over current funding
7 levels. Ms. Keene's proposed change would not affect the 0.875 mill/kwh charge,
8 but would raise the cap on the monthly per-meter charge from 35 cents to 99 cents
9 for residential customers, from \$13 to \$25 for most non-residential customers, and
10 from \$39 to \$100 for customers with billing demands of 3000 kw or greater.

11 The current structure of charges strikes an important balance between
12 meeting the funding goals of the EPS program and limiting the subsidy cost
13 imposed on individual customers, which is accomplished through the per-meter
14 cap. My recommendation for meeting the targeted increase in EPS funding would
15 be to retain this current structure by increasing all billing components – i.e., the
16 energy charge and the per-meter caps, by an equal percentage: in this case, 67
17 percent.¹⁰

18 Although Ms. Keene's proposal does not adhere to a strictly proportional
19 increase, it otherwise retains important aspects of the balance of interests
20 contained in the design of the current surcharge. Therefore, if my preferred option
21 of a strictly proportional increase is not adopted, then I recommend that Ms.
22 Keene's rate design for the Environmental Portfolio Surcharge be approved.

¹⁰ This would result in an EPS energy charge of 1.461 mills/kwh, a residential cap of 58 cents/month, a non-residential cap of \$21.71/month, and a large customer cap of \$65.14/month.

1 **Cost allocation methodology**

2 **Q. Do you have any comments on testimony that addresses cost allocation**
3 **methodology?**

4 A. Yes. In my direct testimony, I supported APS' use of the 4-CP method for
5 allocating fixed production cost. Staff witness Lee Smith and RUCO witness
6 John Stutz have challenged APS' use of this method, and argue for alternatives
7 that would classify more costs as energy-related and less as demand-related,
8 resulting in a re-allocation of cost responsibility from lower-load-factor customer
9 classes to higher-load-factor customer classes.¹¹

10 While, typically, a case can be made for more than one cost allocation
11 method, I believe the 4-CP method is particularly appropriate for the APS
12 territory. The APS system is not a static state, but is characterized by substantial
13 load growth, which has important implications for future costs. The major driver
14 of the need for additional generating resources is the growth in APS' summer
15 peak demand. It is important that APS' cost allocation methodology reflect this
16 underlying cost dynamic. I believe this is best captured by using the 4-CP
17 approach, which reflects the demands put on the system in the peak summer
18 months.

19 Moreover, placing increased cost responsibility on higher-load-factor
20 customers is particularly inappropriate given that APS energy costs are allocated
21 to customer classes without regard to seasonality or time-of-use, despite

¹¹ See pre-filed direct testimony of Lee Smith (Staff), p. 33, line 18 – p. 35, line 5 and pre-filed direct testimony of John Stutz (RUCO), p. 19, line 1 – p. 23, line 16.

1 significant differences in seasonal and time-of-use costs.¹² This means that high-
2 load-factor customer classes – which generally use a higher-than-average portion
3 of their energy in cheaper off-peak periods – are allocated the same average cost
4 of energy as low-load factor customer classes, which generally consume more of
5 their energy requirements during the more expensive on-peak periods. In other
6 words, the allocation of energy costs to classes without regard to seasonality or
7 time-of-use already shifts costs unduly to high-load-factor customers. Moving
8 away from the 4-CP method to one of the proposed alternatives will only
9 exacerbate this problem. Therefore, the Commission should not approve the
10 alternatives proposed to APS' 4-CP method. Instead, ASP' cost-of-service
11 analysis should be accepted.

12 **Q. Do you have any comments on testimony that addresses allocation of**
13 **distribution costs?**

14 A. Yes. RUCO witness John Stutz recommends allocating a portion of
15 distribution system costs based on energy, rather than exclusively on demand.
16 This would result in a greater allocation of distribution costs to high-load-factor
17 customers and a smaller allocation to low-load-factor customers.¹³

18 I disagree with Dr. Stutz's recommendation. While the distribution system
19 certainly is used for the delivery of energy, the investment in distribution system
20 facilities is driven by demand. A low-load-factor customer requires essentially the
21 same investment in distribution facilities as a high-load factor customer, and

¹² Note that the allocation of costs to customer classes is distinct from the inclusion of seasonal or time-of-use features in rate design. APS' rates provide for seasonal and optional time-of-use pricing, which are rate design features applicable to individual rate schedules. However, the allocation of APS energy costs to customer classes in the first instance is not differentiated by seasonality or time-of-use. See AP__WP21.

1 should pay the same cost for the investment required. A high-load factor customer
2 simply uses the distribution system more efficiently. These high-load factor
3 customers would be unfairly penalized by switching to a methodology that
4 allocates distribution system costs on an energy basis. Therefore, I recommend
5 that Dr. Stutz's proposal not be adopted.

6 **Q. Does this conclude your rebuttal testimony?**

7 A. Yes, it does.

¹³ Pre-filed direct testimony of John Stutz, p.23, line 18 – p. 24, line 10.