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BEFORE THE ARIZONA CORPORATION COMMISSION

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MARC SPITZER, Chairman
WILLIAM A. MUNDELL
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AZ CORP COMMISSION
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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

Staff hereby provides notice of filing its testimony in support of the settlement agreement in this docket. An original and thirteen copies are submitted of the prefiled testimony of Ernest G. Johnson and Linda A. Jaress, and the staff reports of Matthew Rowell, Barbara Keene, Robert Gray, and Erinn A. Andreasen.

RESPECTFULLY SUBMITTED this 27th day of September 2004.

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**DIRECT
TESTIMONY
OF
ERNEST G. JOHNSON**

LINDA A. JARESS

AND

STAFF REPORTS

OF

MATTHEW ROWELL

BARBARA KEENE

ROBERT GRAY

ERINN A. ANDREASEN

DOCKET NO. E-01345A-03-0437

**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**

SEPTEMBER 27, 2004

BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE APPLICATION OF) DOCKET NO. E-01345A-03-0437
ARIZONA PUBLIC SERVICE COMPANY FOR)
A HEARING TO DETERMINE THE FAIR VALUE)
OF THE UTILITY PROPERTY OF THE COMPANY)
FOR RATEMAKING PURPOSES, TO FIX A JUST)
AND REASONABLE RATE OF RETURN)
THEREON, TO APPROVE RATE SCHEDULES)
DESIGNED TO DEVELOP SUCH RETURN, AND)
FOR APPROVAL OF PURCHASED POWER)
CONTRACT)

DIRECT TESTIMONY

IN SUPPORT OF THE PROPOSED SETTLEMENT AGREEMENT

LINDA A. JARESS

EXECUTIVE CONSULTANT III

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

SEPTEMBER 27, 2004

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

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

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

ACRONYMS

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

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

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

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

COSS - Cost of Service Study

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

OATT - Open Access Transmission Tariff

PSA - Power Supply Adjustor

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

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

TCA - Transmission Cost Adjustor

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

1 **INTRODUCTION**

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

3 A. My name is Linda A. Jaress. I am an Executive Consultant III in the Utilities Division of
4 the Arizona Corporation Commission ("ACC" or "Commission"). My business address is
5 1200 West Washington Street, Phoenix, Arizona 85007.

6
7 **Q. Did you provide direct testimony in this docket?**

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

10

11 **Q. What is the purpose of this testimony?**

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

14

15 **THE SETTLEMENT AGREEMENT**

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

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

24

25 The Settlement Agreement is in the public interest not only because it represents a
26 consensus of the vast majority of the parties, but also because it provides long-term
27 benefits to the customers of APS and the citizens of Arizona. For example, the reduction

1 in the value of the Pinnacle West Energy Corporation assets, explained below, is
2 recommended not just for adoption in this case but as a permanent reduction. This would
3 benefit customers for many years, until the assets are fully depreciated. The proposed
4 increase in Demand Side Management spending would have long-term effects on the
5 reduction in APS' need for new generation. The provision requiring APS to issue a
6 special RFP for renewables in 2005 is a positive step toward providing long-term
7 improvements to the natural environment in Arizona

8
9 Staff, then, believes that adoption of the Settlement Agreement in its entirety by the
10 Commission would provide long-term benefits to every party to the Agreement and to the
11 people of Arizona. We further believe that the resulting revenue requirement is fair and
12 that it is in the public interest for the Commission to approve the Settlement Agreement in
13 its entirety.

14
15 **REVENUE REQUIREMENT**

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

18 A. On June 27, 2003, APS filed an application to increase revenues from its customers by
19 \$175.1 million including a proposed additional surcharge of \$8.3 million, which
20 represents the Competition Rules Compliance Charge ("CRCC"). Staff's direct
21 testimony, filed in February, 2004, recommended a net reduction of \$142.7 million which
22 included a \$7.4 million CRCC surcharge. The direct testimony of the Residential Utility
23 Consumer Office ("RUCO") supported a decrease of \$53.61 million. Arizonans for
24 Choice and Competition ("AECC"), representing businesses who support the
25 advancement of retail competition, recommended adjustments to APS' request that
26 resulted in a revenue requirement increase of approximately \$25.0 million. Ultimately,

1 the parties agreed to a base rate increase of \$67.6 million with an additional CRCC
2 surcharge of \$7.9 million, for a total increase of \$75.5 million.

3
4 **Q. Please explain how the ultimate revenue requirement of \$75.5 million was**
5 **determined.**

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

15
16 **Q. What are the most significant differences between the Settlement Agreement and**
17 **Staff's direct testimony?**

18 A. Certainly the issue that had the greatest impact on the movement from Staff's revenue
19 requirement recommendation in its direct case to the revenue requirement in the
20 Settlement Agreement was the transfer and inclusion of certain Pinnacle West Energy
21 Corporation ("PWEC") generation assets in APS' rate base, at the reduced value that will
22 be discussed below. The revenue requirement impact from this change was approximately
23 \$76 million.

24
25 The adoption by the Settlement Agreement of more current fuel, purchased power
26 expenses and off-system sales margins, as presented in APS' rebuttal testimony, increased
27 the revenue requirement by approximately \$34 million. The negotiated capital structure

1 and cost of debt and equity levels also had a significant effect, increasing the revenue
2 requirement from Staff's original proposal by approximately \$35 million. Similarly, the
3 resolution of depreciation issues and nuclear decommissioning expense issues resulted in
4 an increase to Staff's revenue requirement position of approximately \$33 million.

5
6 **Q. Do the adjustments related to these five issues total the entire change from Staff's**
7 **direct testimony?**

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

16
17 **Q. Does Staff's concurrence with the Settlement Agreement revenue requirement mean**
18 **that Staff concluded that it could not support its direct case?**

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

22
23
24
25
26

1 **PWEC ASSETS AND ELECTRIC COMPETITION**

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

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

18
19 There was also substantial testimony regarding the status of electric restructuring in
20 Arizona filed by several parties. Among the positions put forth, RUCO urged the
21 Commission to scrap electric restructuring completely. The Arizona Community Action
22 Association ("ACAA"), which represents low-income customers, urged the Commission
23 to protect low-income customers from bearing the cost of rectifying the electric
24 restructuring that they had opposed. Other parties filed testimony on the damage that
25 transferring the PWEC assets to APS would cause the electricity market in Arizona.
26

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

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

7
8 **Q. At what value did the parties agree to include the PWEC assets in rate base and**
9 **why?**

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

14
15 **Q. What does the difference between \$848.0 million and \$700.0 million represent?**

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

23
24 **Q. What impact will the transfer of the PWEC assets have on electric competition in**
25 **Arizona?**

26 A. Although the Agreement proposes to transfer and rate base the PWEC assets, which APS
27 requested, it also proposes actions to counteract any perceived detriment to electric

1 competition in Arizona that the transfer could cause. For example, APS has agreed not to
2 self-build generation for ten years (unless certain, specific circumstances occur), allowing
3 the merchant electric industry opportunities to supply some of APS' generation needs.
4 Also, APS agreed to issue an RFP during 2005 seeking long-term resources of 1000 MW
5 or more for 2007 and beyond. This solicitation will further support the development of a
6 competitive electricity market in Arizona.

7
8 The road that electric competition has traveled in Arizona has been rocky. However, Staff
9 believes that adoption of the Settlement Agreement will enable smoother traveling. The
10 combination of the transfer of the PWEC assets (at a reduced value) to APS, along with
11 the ten-year prohibition against self-building and the issuance by APS of an RFP for a
12 significant amount of power will enhance the potential development of electric
13 competition in Arizona. Finally, adoption of these segments of the Agreement by the
14 Commission will likely eliminate potential appeals, contribute to the protection of the
15 financial health of one of Arizona's largest corporations and employers, and promote the
16 development of the market for merchant electricity.

17
18 **POWER SUPPLY ADJUSTOR**

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

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

1

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

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

10

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

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

21

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

25 A. Yes, they did. On page 4 of the proposed Agreement, the parties agreed that within the
26 PSA, "[t]here shall be an incentive mechanism where APS and its customers shall share in
27 the costs or savings. The percentage of sharing shall be ninety (90) percent for the

1 customers and ten (10) percent for APS with no maximum sharing amount.” This, in
2 effect, creates a deadband whereby ten percent of the fuel and purchased power costs that
3 exceed base power costs will be absorbed by the Company; similarly, ten percent of any
4 fuel and purchased power savings will be absorbed by the Company.

5

6 **Q. What are the benefits of this mechanism?**

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

10

11 **Q. Did this adjustor affect revenue requirements?**

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

17

18 **DEPRECIATION**

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

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

26

27

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

2 A. Only APS and Staff supplied such testimony.

3
4 **Q. When were APS' current depreciation rates adopted?**

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

8
9 **Q. What adjustments to test year depreciation did the parties make in the direct case?**

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

13
14 **Q. What is SFAS No. 143, and what is its relevance to this rate case?**

15 A. As discussed in direct and rebuttal testimony, the Financial Accounting Standards Board
16 ("FASB") issued a statement (SFAS No. 143), which was implemented on January 1,
17 2003, one day after the end of the test year in this case. SFAS No. 143 requires companies
18 to limit the asset retirement obligations recorded in depreciation expense to those asset
19 retirement obligations that are required by law. For example, there are legal requirements
20 that, at retirement, APS must dismantle certain plants and properly dispose of them. Thus,
21 when APS calculates annual depreciation for these plants, it includes an amount in
22 depreciation expense attributable to the cost of removal.

23
24 In the absence of a legal requirement to remove an asset, SFAS No. 143 prohibits
25 companies from including the estimated future cost of removal in the annual depreciation
26 expense for that asset. For example, expected costs to dispose of old computers or service
27 trucks are not included in depreciation rates for those items. However, in the past, APS

1 has included the estimated cost of removal of such assets in its depreciation rates. Thus,
2 Staff recommended an unbundled, identifiable net salvage allowance that could be
3 included as a component of depreciation expense and recorded in accumulated
4 depreciation.

5
6 APS argued that SFAS 143 applies to financial accounting and not regulatory accounting.
7 APS also argued that the Commission has long been aware that APS includes in
8 depreciation expense the estimated future cost of removal of assets for which there is no
9 legal retirement obligation and that such recovery has been included in APS' approved
10 depreciation rates for many years. APS has not separately accounted for the cost of
11 removal of such assets, so any current or future adjustment to depreciation expense based
12 upon SFAS 143 would be the result of gross estimates.

13
14 **Q. What other issue did Staff raise in its direct testimony regarding depreciation?**

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

19
20 **Q. How does the Settlement Agreement address the SFAS No. 143 issue and the service**
21 **lives issue?**

22 A. APS agreed to adopt Staff's recommended depreciation lives and to separately record and
23 account for projected costs of removal and salvage within depreciation expense so that
24 they can be identified in future rate cases. The Agreement provides that APS may
25 continue to record all asset retirement obligations in depreciation expense in the manner
26 reflected in their filing until further order of the Commission.
27

1 **Q. What is the benefit of settling these issues?**

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

8
9 **COST OF CAPITAL AND CAPITAL STRUCTURE**

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

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

17
18 RUCO recommended a capital structure of 53.83 percent at a cost of 5.77 percent, 1.03
19 percent short-term debt at a cost of 3.0 percent, and common equity of 45.24 percent at a
20 cost of 9.5 percent.

21
22 With the inclusion of the PWEC assets in rate base, APS requested a capital structure
23 comprised of 54.95 percent of long-term debt at a cost of 5.76 percent and common equity
24 of 45.05 percent at a cost of 11.5 percent.

25
26
27

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

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

9
10 **DEMAND SIDE MANAGEMENT**

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

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

18
19 In its surrebuttal testimony, APS agreed that an expanded DSM program funded at an
20 initial \$3.0 million per year and capped at \$10.0 million per year would be reasonable.
21 For expenditures under that \$10.0 million ceiling, APS would be permitted to collect net
22 lost revenues, incremental staffing costs, and future funding requirements resulting from
23 DSM workshops or subsequent proceedings.

24
25 **Q. How did the Settlement Agreement resolve these huge differences?**

26 A. Included in the base rate increase proposed by the Settlement Agreement is \$10.0 million
27 for expenditures on approved, eligible methods of DSM. An adjustor is also proposed that

1 would recover a required, additional \$6.0 million per year on DSM. This would result in
2 \$48.0 million of funding over the three years 2005 through 2007.

3

4 **Q. Why is this a good compromise?**

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

17

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

21

22

23

24

25

1 **ENVIRONMENTAL PORTFOLIO STANDARD AND OTHER RENEWABLES**

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

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

10
11 RUCO recommended that \$6.0 million of the proposed EPS funding be "reassigned" to
12 DSM, thereby placing lesser emphasis on renewables.

13
14 **Q. How does the Settlement Agreement resolve these concerns?**

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

24
25 Currently, the monthly cap on the EPS surcharge that APS could collect from residential
26 customers is \$0.35 and \$13.00 from non-residential customers under 3 MW. For non-
27 residential customers 3 MW and over, \$39 per month could be collected. As will be

1 discussed below, organizations representing large non-residential customers claim that
2 their rates are subsidizing residential customers. The Settlement Agreement addresses this
3 perceived imbalance; if the Commission increases the total amount of EPS funding before
4 the next APS rate case, the proportion absorbed by non-residential customers will be
5 identical to the proportion of total funding currently provided by non-residential
6 customers.

7
8 **Q. Why is this a good compromise?**

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

12
13 **TRANSMISSION COST ADJUSTOR**

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

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

21
22 **Q. What were the positions of the parties in the direct case?**

23 A. Staff supported the implementation of the TCA in its direct testimony because without a
24 TCA, customers’ choice between direct access service and standard offer service could be
25 distorted. RUCO’s testimony recommended that the TCA be denied and that the
26 Commission retain “local control” over the transmission aspect of APS’ operations.
27

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

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

6
7 **Q. How is this an equitable solution?**

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

11
12 **BARK BEETLE REMEDIATION**

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

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

20
21 The Settlement Agreement proposes to allow APS to defer, for possible future recovery,
22 the reasonable and prudent direct costs of bark beetle remediation that exceed test year
23 levels of tree and brush control. The deferral account shall not accrue interest and will be
24 subject to Commission review in APS' next rate case. The parties believe this is a
25 preferred and more precise method of recovery than asking the Commission to pre-
26 approve an estimated level of costs.
27

1 **NUCLEAR DECOMMISSIONING FUND**

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

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

11
12 APS argued that there is no reason to change the funding levels which are under the
13 oversight of the NRC and GAO and have been determined in the past to be adequately
14 funded. APS also argued that the current funding levels have been approved by all of the
15 other Palo Verde participants and that changing them would be difficult procedurally.

16
17 The Settlement Agreement proposes to adopt APS' recommended level of
18 decommissioning costs. Staff accepted APS' arguments to a degree, but primarily agreed
19 to the current level of funding based upon the possible negative consequences of
20 underfunding.

21
22 **COST OF SERVICE AND RATE DESIGN**

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

25 A. The positions of the parties on these issues are especially disparate. Except for the method
26 of allocation of generation capacity set forth by APS, Staff supported APS' choice of
27 allocators. Staff also provided testimony that, although cost is an important factor in

1 spreading revenue requirement among customer classes and rates, it is not the only factor
2 that should be considered.

3
4 RUCO's testimony indicated that APS' cost of service study overstates the cost of serving
5 residential customers and that APS' revenue spread does not conform to good ratemaking
6 principles.

7
8 Kroger Company presented issues related to APS' proposed voltage levels in the design of
9 E-32 rates but did not oppose the methodology APS used in its COSS.

10
11 The Federal Executive Agencies ("FEA") recommended approval of APS' COSS
12 methodology, but rejected APS revenue spread. FEA asked the Commission to move
13 rates closer to cost, to reduce APS' proposed transmission voltage discount and to increase
14 the primary voltage discount.

15
16 **Q. How were these issues resolved?**

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

25
26 APS would also establish a Primary Service Discount exclusively for military base
27 customers who are served directly from APS substations. This action reflects the

1 importance to the Arizona economy in general, and specifically to APS' system, of
2 retaining the federal agencies locations in Arizona.

3
4 **Q. What other rate design related benefits are reflected in the Settlement Agreement?**

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

9
10 Certain rate schedules were streamlined and others clarified, making them more easily
11 understood by the customers and better enabling customers to choose the best rate for their
12 usage patterns. Finally, the rate schedules contained in the Settlement Agreement enhance
13 the opportunity for retail access through the unbundling of standard offer rates and the
14 pricing of certain competitive service rate elements to reflect cost. This provides
15 customers with the price signals they need to make informed decisions about shopping for
16 competitive services.

17
18 **Q. Are the rates that resulted from the negotiations fair?**

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

22
23 **LITIGATION AND OTHER ISSUES**

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

26 A. APS appealed the Track A order in both Superior Court and the Court of Appeals.
27 Affiliates of APS also initiated another lawsuit, which includes breach of contract claims

1 allegedly related to the Track A order, in Superior Court. APS contends in these various
2 appeals that it should be compensated for monetary damages allegedly caused by the
3 Commission. All of these actions are inactive at the present time, and the parties await the
4 outcome of this proceeding.

5
6 Any lawsuit creates risk, and Staff recognizes that if APS were to succeed in these claims,
7 ratepayers and/or taxpayers may have to bear significant costs. The Settlement Agreement
8 proposes to resolve these matters. Specifically, APS has agreed to drop its appeals of the
9 Track A order and Decision No. 61973 and to forever forego any claim that APS, PWEC,
10 Pinnacle West Capital Corporation or any of its affiliates were harmed by these decisions.
11 APS has also agreed not to seek recovery of the \$234 million write-off recorded at the
12 time of the 1999 settlement agreement in any future proceeding. Thus the determination
13 of alleged harm related to these decisions and related monetary impacts will not be raised
14 by APS in future cases.

15
16 The withdrawal of these court cases would relieve the ratepayers of any risk related to a
17 possible negative outcome. The issue of \$234 million (and possibly more) that APS
18 believes the ratepayers owe them would disappear with the dismissal of these cases. The
19 resolution of these cases, along with resolution of the Preliminary Inquiry ordered in
20 Commission Decision No. 65796, would essentially "clear the decks" of risky, protracted,
21 complicated proceedings that if not resolved would likely continue generating high costs
22 for all affected parties in terms of time, effort and personnel.

23
24 **Q. Does this conclude your direct testimony?**

25 **A. Yes, it does.**

BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE APPLICATION OF) DOCKET NO. E-01345A-03-0437
ARIZONA PUBLIC SERVICE COMPANY FOR A)
HEARING TO DETERMINE THE FAIR VALUE)
OF THE UTILITY PROPERTY OF THE)
COMPANY FOR RATE MAKING 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)
_____)

DIRECT TESTIMONY

IN SUPPORT OF THE PROPOSED SETTLEMENT AGREEMENT

ERNEST G. JOHNSON

DIRECTOR

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

SEPTEMBER 27, 2004

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

Mr. Johnson provides policy level testimony which summarizes the Settlement process, provides reasons which support Staff's conclusions that the Settlement Agreement is in the public interest and addresses several general policy considerations. Mr. Johnson concludes that the Settlement Agreement is fair, balanced and in the public interest. Mr. Johnson asserts the following as support for Staff's conclusion that the Settlement Agreement is in the public interest:

- Staff believes that the agreement is fair to ratepayers because it precludes inappropriate utility profits and results in just and reasonable rates for consumers.
- Staff believes that it is fair to the utility because it provides revenues necessary for the utility to provide reliable electric service along with an opportunity for a reasonable profit.
- Staff believes that this proposal balances many diverse interests including those of low income customers, the renewable energy sector, DSM advocates, merchant generators and retail energy marketers.
- Staff believes that the Agreement is in the public interest because it allows APS to rate base the PWEC Assets, which are the generating plants originally built by APS' affiliate Pinnacle West Energy Corporation, at a value significantly below their book value.
- Although the Agreement calls for rate basing the PWEC Assets, it also addresses potentially anti-competitive effects associated with such rate basing. The Agreement adopts a self-build moratorium, provides for a competitive solicitation in 2005, and requires Staff to conduct workshops to address future resource planning and acquisition issues. In addition, the rate design section encourages general service customers, which are the customers most attractive to new competitors, to shop for competitive services by adopting cost-based unbundling for generation and revenue cycle services. These provisions are intended to promote competition.
- Staff believes that the Settlement eliminates long, complex litigation by resolving issues associated with prior Commission decisions that are currently on appeal (Track A and certain rate case issues). If the Agreement is approved, these appeals will be dropped.
- Staff believes that the Agreement promotes the public interest by facilitating the provision of reliable electric service at the lowest reasonable rates.

- The Agreement provides additional discounts to low-income APS customers, increases funding for advertising these discounts, and increases funding for APS' low-income weatherization program.
- The Agreement sets forth a comprehensive DSM proposal, which is intended to foster the development of new DSM programs. Significantly, the DSM section of the Agreement also includes provisions to ensure that DSM expenditures will be reasonable and that the Commission will be able to maintain appropriate oversight.

Finally, in concluding that the Settlement Agreement is in the public interest, Mr. Johnson notes that the Agreement addresses and resolves all of the main rate case issues, provides sufficient revenues and return for APS to maintain reliable electric service and results in rates and charges which Staff believes are just and reasonable.

INTRODUCTION/SUMMARY

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Q. Please state your name and business address.

A. My name is Ernest G. Johnson, 1200 West Washington Street, Phoenix, Arizona 85007.

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

A. I am employed by the Arizona Corporation Commission (“ACC” or “Commission”) as the Director of the Utilities Division.

Q. Briefly describe your responsibilities as Utilities Director.

A. I am responsible for the day-to-day operations of the Utilities Division, including policy development, case strategy and overall Division management.

Q. Please summarize your educational background and professional experience.

A. In 1979 and 1982, respectively, I earned Bachelor of Science and Juris Doctorate degrees, both from the University of Oklahoma. I have been involved in the regulation of public utilities since 1986. I was employed by the Oklahoma Corporation Commission in 1986 in various legal capacities. In 1993, I was named acting Director and served in that position until mid-1994. I served as permanent Director from mid-1994 until October 2001. In October of 2001, I assumed my current position with the Arizona Corporation Commission. While serving in these capacities, I have participated in numerous regulatory proceedings including providing policy analysis concerning Electric Restructuring before the Oklahoma Corporation Commission, the Oklahoma State Legislature, and the Arizona Commission.

1 **Q. Did you participate in the negotiations that led up to the execution of the Proposed**
2 **Agreement?**

3 A. Yes, I did.
4

5 **Q. What is the purpose of your testimony in this case?**

6 A. I will provide testimony which addresses the settlement process, public interest and
7 general policy considerations.
8

9 **Q. How is your testimony being presented?**

10 A. My testimony is organized into three sections. Section I provides discussion and insight
11 into the Settlement process. Section II identifies and discusses the reasons why the
12 Settlement Agreement ("Agreement") is in the public interest. Section III addresses
13 several general policy considerations.
14

15 **Q. Who else is providing Staff testimony and what issues will they address?**

16 A. Staff will present the following witnesses:

- 17
- 18 • Ms. Linda Jaress provides testimony explaining why approval of the
19 Settlement Agreement is in the public interest and why Staff entered the
20 Agreement.
21
 - 22 • Mr. Matt Rowell provides testimony in the form of a Staff report concerning
23 the treatment of certain PWEC generation assets and the treatment of
24 competitive issues.
25
 - 26 • Ms. Barbara Keene provides testimony in the form of a Staff report covering
27 Demand Side Management, Renewables and Distributed Generation. Ms.
28 Keene also addresses the low-income programs, adjustor mechanisms and
29 service schedules.
30
 - 31 • Mr. Bob Gray provides testimony in the form of a Staff report which
32 principally addresses various adjustment Mechanisms.
33
 - 34 • Ms. Erinn Andreasen provides testimony in the form of a Staff report
35 concerning Rate Design.

SECTION I - SETTLEMENT PROCESS

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Q. Please discuss the Settlement process.

A. In my 18 years of experience in utilities regulation, this process was unprecedented and unparalleled in its breadth and scope. There were more than 30 parties representing every possible viewpoint – advocates for consumers, including low-income customers and seniors; advocates for retail competition, and even other utilities. Working together over the past approximately four months, we have managed to craft a proposed solution that satisfies nearly all of those diverse interests. If we were unable to resolve a specific issue, we set up a process for that issue to be examined and addressed in the future.

Q. How many Settlement meetings were held?

A. During the period of April 19, 2004 through August 11, 2004, approximately twenty (20) meetings were held.

Q. Who participated in those meetings?

A. Generally, most interests were represented; attendees included Arizona Public Service Company (“APS”), Residential Utility Consumer Office (“RUCO”), Staff, and most intervenors.

Q. Could you identify some of the diverse interests that were involved in this process?

A. Yes. Diverse interests included consumer representatives, merchant plants, large customers of APS, solar interests, environmental interests, and demand side management (“DSM”) advocates, just to name a few.

Q. How many of these parties executed the stipulation?

A. The Agreement was executed by twenty-two (22) parties.

1 **Q. How many parties did not sign the Agreement, but nonetheless do not oppose the**
2 **Agreement?**

3 A. There are five parties who I would describe as not opposed but not signing the Agreement.
4

5 **Q. How many parties oppose the Agreement?**

6 A. Only one party stated its opposition to the Agreement.
7

8 **Q. Who is that party?**

9 A. The Arizona Cogeneration Association ("ACA").
10

11 **Q. Why is Arizona Cogeneration Association opposing the Agreement?**

12 A. It is my understanding that the ACA believes that certain rate structures contained within
13 the Agreement do not encourage distributed generation.
14

15 **Q. In your opinion, was there an opportunity for all issues to be discussed and**
16 **considered?**

17 A. Yes. In my opinion, the issues of concern to the ACA were seriously considered, certainly
18 by Staff. Unfortunately, up to this point, we have been unable to resolve them.
19 Nonetheless, the Agreement provides for a process designed to facilitate further discussion
20 and hopefully resolution of these issues.
21

22 **Q. Mr. Johnson, what process are you referring to?**

23 A. I am referring to Section XVII of the Agreement which provides that the ACC Staff will
24 schedule workshops to consider outstanding issues affecting distributed generation. The
25 Agreement further provides for the initiation of a rule making proceeding as may be
26 necessary.

1 **Q. How would you describe the negotiations?**

2 A. I believe that all participants zealously advocated and represented the interests of their
3 constituents. As might be expected, at times the discussions became quite contentious and
4 global resolution of the multitude of very complex issues appeared to be no more than
5 wishful thinking. However, I am extremely pleased with the desire and effort put forth by
6 all parties. While acknowledging that not all parties executed the Agreement, I must note
7 that all parties had the opportunity to be heard and to have their issues fairly considered.
8

9 **Q. Mr. Johnson, would you describe the process as requiring a lot of give and take?**

10 A. Yes, I would. As a result of the many and varied interests represented in the Settlement
11 process, a willingness to compromise was absolutely necessary. As evidenced in the
12 Agreement, the signatories compromised vastly different litigation positions.
13

14 **Q. In your previous response, you stated that the parties compromised litigation
15 positions. Is that correct?**

16 A. Yes.
17

18 **Q. In your opinion, was the public interest unduly compromised?**

19 A. No, not in my opinion. As I will discuss later in this testimony, I believe that the
20 compromises made by the various parties will actually further the public interest.
21

22 **Q. Mr. Johnson, are there any other comments you would like to make in regard to the
23 Settlement process?**

24 A. Yes. I am very pleased with the outcome of the negotiations and I want very much to
25 thank all parties for their diligent participation in the process. It was difficult at times to
26 ensure that all parties had an opportunity to be fully aware of all discussions among and

1 between participants, especially when some were interested in very narrow issues. In fact,
2 at times, it appeared that extreme efforts were being undertaken to provide opportunities
3 for participation.

4
5 **SECTION II - PUBLIC INTEREST**

6 **Q. Turning now to the issue of public interest. Mr. Johnson, in Staff's opinion, is the**
7 **Proposed Settlement in the public interest?**

8 A. Yes, absolutely. In Staff's opinion, the Proposed Settlement is fair, balanced and in the
9 public interest.

10
11 **Q. Mr. Johnson, would you briefly summarize the reasons that Staff concludes that the**
12 **Settlement is fair, balanced and in the public interest.**

13 A. Yes, the following points support Staff's view:

- 14
- 15 • Staff believes that the agreement is fair to ratepayers because it precludes
16 inappropriate utility profits and results in just and reasonable rates for consumers.
17
 - 18 • Staff believes that it is fair to the utility because it provides revenues necessary for the
19 utility to provide reliable electric service along with an opportunity for a reasonable
20 profit.
21
 - 22 • Staff believes that this proposal balances many diverse interests including those of low
23 income customers, the renewable energy sector, DSM advocates, merchant generators
24 and retail energy marketers.
25
 - 26 • Staff believes that the Agreement is in the public interest because it allows APS to rate
27 base the PWEC Assets, which are the generating plants originally built by APS'
28 affiliate Pinnacle West Energy Corporation, at a value significantly below their book
29 value.
30
 - 31 • Although the Agreement calls for rate basing the PWEC Assets, it also addresses
32 potentially anti-competitive effects associated with such rate basing. The Agreement
33 adopts a self-build moratorium, provides for a competitive solicitation in 2005, and
34 requires Staff to conduct workshops to address future resource planning and
35 acquisition issues. In addition, the rate design section encourages general service

1 customers which are the customers most attractive to new competitors, to shop for
2 competitive services by adopting cost-based unbundling for generation and revenue
3 cycle services. These provisions are intended to promote competition.
4

- 5 • Staff believes that the Settlement eliminates long, complex litigation by resolving
6 issues associated with prior Commission decisions that are currently on appeal (Track
7 A and certain rate case issues). If the Agreement is approved, these appeals will be
8 dropped.
9
- 10 • Staff believes that the Agreement promotes the public interest by facilitating the
11 provision of reliable electric service at the lowest reasonable rates.
12
- 13 • The Agreement provides additional discounts to low income APS customers, increases
14 funding for advertising these discounts, and increases funding for APS' low-income
15 weatherization program.
16
- 17 • The Agreement sets forth a comprehensive DSM proposal, which is intended to foster
18 the development of new DSM programs. Significantly, the DSM section of the
19 Agreement also includes provisions to ensure that DSM expenditures will be
20 reasonable and that the Commission will be able to maintain appropriate oversight.
21

22
23 **Q. Turning to your first point, you suggest that the Settlement precludes inappropriate**
24 **utility profits and results in just and reasonable rates for consumers. Please explain.**

25 A. Yes. APS filed its Application seeking to increase base rates by approximately \$166.8
26 million and to recover approximately \$8.3 million through a Competition Rules
27 Compliance Charge ("CRCC") surcharge. Under the Settlement, the base rate increase is
28 reduced by approximately \$100 million. The proposed Agreement provides for a modest
29 increase in base rates of approximately \$67.6 million and a CRCC surcharge of \$7.9
30 million. The proposed revenue requirement contained in the Settlement is approximately
31 60 percent less than the revenue requirement requested by the Company (4.21 percent
32 increase in lieu of a 9.8 percent increase). This Agreement allows ratepayers to keep very
33 significant amounts of money in their pockets.

1 **Q. Please discuss how the Settlement is fair to the utility.**

2 A. Staff believes that the Agreement is fair to the utility because it provides an opportunity
3 for APS to earn revenues sufficient for the utility to provide reliable electric service and to
4 achieve a reasonable profit. Illustratively, the Settlement would provide APS with
5 revenues which would allow it an opportunity to earn an overall rate of return of
6 approximately 5.97 percent and a 10.25 percent return on equity. In Staff's opinion, these
7 returns would enable APS to provide reliable service at reasonable rates.

8
9 **Q. Mr. Johnson, you have indicated that the Settlement Proposal incorporates many**
10 **diverse interests including those of low-income customers, the renewable energy**
11 **sector, DSM advocates, merchant generators and retail energy marketers. Please**
12 **elaborate.**

13 A. Within the Agreement, there are specific provisions which address many of the concerns
14 expressed by the above-referenced interests. By way of example, I would submit the
15 following:

16
17 **Competitive Procurement of Power**

18 This issue is more fully addressed in the Staff Report of Mr. Matt Rowell. But as he
19 generally notes, in order to settle matters relating to competition and the procurement of
20 APS' power from the competitive market, the Parties agreed that APS would not build
21 new, large central station generation with an in-service date before 2015. The self build
22 moratorium is subject to a safety mechanism that permits APS to seek an exemption from
23 the Commission if the wholesale market cannot cost effectively meet the needs of APS'
24 customers. These provisions are designed to retain the opportunity for the competitive
25 power marketplace to meet some of APS' generation needs. In my view, over time, and as

1 an outgrowth of this Settlement, we will be able to better assess the ability of the
2 marketplace to provide reliable, reasonably priced generation to APS' rate payers.

3
4 **Renewable Energy**

5 Under the Agreement, APS has committed to issuing a Request for Proposal in 2005
6 seeking at least 100 MW and 250,000 MWh per year of electricity generated by solar,
7 biomass/biogas, wind, small hydro, hydrogen or geothermal resources. This provision
8 should provide an opportunity for renewable sources to further demonstrate value as a
9 reliable component of the generation portfolio of APS.

10
11 **Demand Side Management**

12 Many parties had a particular interest in the issue of DSM. The Agreement calls for a
13 large increase in expenditures for energy efficiency DSM which would include up to \$1.0
14 million which could be used for low-income weatherization projects/programs. Staff
15 places the highest priority on programs to develop energy efficient schools during new
16 construction and by retrofitting. By utilizing energy efficient DSM programs, schools will
17 be able to lower utility bills, thereby freeing up additional dollars for student education
18 and teacher pay. This ultimately could translate into savings for taxpayers.

19
20 **Q. How does the Agreement address regulatory issues and unification of assets as it
21 relates to the Pinnacle West Energy Corporation ("PWEC") Assets?**

22 **A.** The PWEC assets being transferred consist of the West Phoenix 4 and 5, Saguaro 3, and
23 Redhawk 1 and 2 generating plants. In its application, APS requested approval to acquire
24 the PWEC assets and to receive rate base treatment of the assets at their book value of
25 \$883.0 million. The Agreement proposes the transfer of the assets to APS and inclusion in
26 rate base at the reduced amount of \$700.00 million. Thus, the Company's concern

1 regarding unification of assets and the regulatory treatment accorded to those assets will
2 be known and certain.

3
4 **Q. Mr. Johnson, you suggested that the Agreement is in the public interest because if**
5 **approved, it would eliminate long, complex litigation. Please explain.**

6 A. With Commission approval of the Agreement, several legal matters would be settled. The
7 Parties agreed that the Preliminary Inquiry regarding APS compliance with the Electric
8 Competition Rules would be concluded without further action by the Commission. Upon
9 approval of the Agreement, APS and its affiliates will forego any claim that they were
10 harmful by Commission Decision No. 65154 (the Track A Decision). Furthermore, APS
11 would dismiss with prejudice all of its appeals of Decision No. 65154 and all litigation
12 related to Decision Nos. 65154 and 61973. In Staff's view, continued litigation along with
13 the risks attendant thereto, could result in increased costs to rate payers without any
14 recognizable benefits.

15
16 **Q. Please discuss your contention that the Agreement promotes the public interest by**
17 **facilitating reliable electric service at the lowest reasonable rates.**

18 A. As previously stated, the Settlement would allow APS the opportunity to earn an overall
19 return of 5.79 percent and a 10.25 percent return on equity. In Staff's opinion, APS
20 should have sufficient revenues and reasonable access to capital, which will allow it to
21 properly maintain its system and provide reliable electric service.

22
23 **Q. What impact will the Settlement have on low-income customers?**

24 A. As previously stated, the Agreement calls for a modest base rate increase. It was the
25 parties' intent to insulate eligible low-income customers from a rate increase. As a result,

1 if the Agreement is approved, nearly all low-income customers would receive a net
2 reduction in rates.

3
4 **Q. Please explain.**

5 A. Basically, the Agreement adopts a higher rate discount for this group. Illustratively,
6 qualifying low-income customers using 401 to 800 kWh currently receive a 20 percent
7 discount. The discount would increase from 20 percent to 26 percent and would
8 completely offset any increase that the eligible low-income customer may have
9 experienced. This increased discount would be in addition to the approximate \$1.0
10 million available through the DSM allowance to be used for low-income weatherization
11 programs and bill assistance.

12
13 **SECTION III - POLICY CONSIDERATIONS**

14 **Q. Mr. Johnson, in its direct testimony, did Staff recommend against including the**
15 **PWEC generation assets in rate base?**

16 A. Yes.

17
18 **Q. Is it not true that the Proposed Agreement provides for rate base inclusion of those**
19 **assets?**

20 A. Yes.

21
22 **Q. Could you discuss why Staff withdrew its opposition to rate basing the PWEC**
23 **generation units?**

24 A. Yes. In its initial testimony, Staff challenged APS to properly support its request to
25 include the five new power plants in rate base. In the absence of persuasive testimony to
26 move the plants into rate base in APS' original application, Staff was compelled to

1 recommend against inclusion. To its credit, in its rebuttal case, APS provided additional
2 data and made additional arguments. These submittals, while not being conclusive as to
3 the issue of the appropriate treatment of the PWEC assets, did warrant further analysis and
4 serious consideration by Staff. However, among other things, Staff still questioned the
5 valuation of the generating plants. Staff was able to reconcile its initial opposition when
6 APS agreed to a significantly reduced valuation and when APS agreed to forego claims to
7 \$234 million, which APS had alleged it should recover from ratepayers as a result of the
8 Track A order.

9
10 **Q. Were there additional reasons?**

11 A. Yes. As more fully discussed in the testimony of Mr. Matt Rowell, the Agreement
12 provides for substantial commitments by APS to market-based approaches aimed at
13 meeting future capacity needs. It is anticipated that the self build moratorium and RFP
14 commitments set forth in Section IX of the Agreement will expand the competitive
15 alternatives available to APS. Finally, in reviewing the totality of the Proposed
16 Agreement, Staff was persuaded that on balance inclusion of the PWEC assets as outlined
17 above was not inappropriate.

18
19 **Q. Mr. Johnson, how does Staff reconcile moving from a rate reduction scenario to a
20 rate increase scenario?**

21 A. The testimony of Ms. Linda Jaress offers a more complete discussion of the basis for the
22 revenue requirement set forth in the Agreement. In this testimony, I address the policy
23 reasons underlying Staff's change in position. As a policy matter, the single most
24 significant revenue requirement issue was determining the appropriate regulatory
25 treatment to be afforded to the PWEC assets. The revenue requirement associated with
26 these generation plants was approximately \$100 million annually. As stated previously,

1 Staff's initial testimony challenged APS to properly support its request to include the five
2 power plants in its rate base. In our view, the Company's initial testimony failed to
3 demonstrate that inclusion of those assets was the best option for ratepayers, especially at
4 the valuation proposed by the Company. In the absence of persuasive testimony
5 supporting inclusion (in addition to other accounting adjustments), Staff was compelled to
6 recommend a rate decrease.

7
8 **Q. Does the Agreement strike an appropriate balance between the diverse needs of the**
9 **interested parties?**

10 A. Yes. Staff believes that the Agreement as a whole mitigates the impact on ratepayers
11 associated with rate basing the PWEC assets and balances the potentially anti-competitive
12 effects of rate basing with certain pro-competitive provisions. The ratepayer impact is
13 mitigated because the assets are being added to the rate base at a value substantially less
14 than their book value. Also, because the Settlement provides for APS to drop its pending
15 Track A related lawsuits against the Commission, rate payers will not face the risk of
16 having to fund a \$234 million (or more) judgment in APS' favor.

17
18 **Q. As a policy matter, why should the Commission approve the Settlement Agreement?**

19 A. The Settlement Agreement addresses and resolves all of the major rate case issues and
20 results in rates which we believe are just and reasonable. Staff believes that the agreed
21 upon revenue requirement is sufficient for APS to maintain reliable service to its
22 customers and to provide a fair return to its investors while causing only a modest increase
23 in rates.

24
25 **Q. Does this conclude your direct testimony?**

26 A. Yes, it does.

MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: September 27, 2004

RE: STAFF REPORT ON THE TREATMENT OF COMPETITIVE ISSUES AND CERTAIN PINNACLE WEST ENERGY CORPORATION'S ASSETS CONTAINED IN THE PROPOSED SETTLEMENT AGREEMENT OF ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR RATE ADJUSTMENT (DOCKET NO. E-01345A-03-0437)

Attached is the Staff Report on the Treatment of Competitive Issues and Certain Pinnacle West Energy Corporation's ("PWEC") Assets Contained in the Proposed Settlement Agreement of Arizona Public Service Company's Request for Rate Adjustment. Staff recommends approval of the settlement agreement.

EGJ:MJR:rdp

Originator: Matthew Rowell

Attachment: Original and thirteen copies

Service List for: Arizona Public Service Company
Docket No. E-01345A-03-0437)

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-03-0437

**TREATMENT OF COMPETITIVE ISSUES AND CERTAIN PWEC ASSETS
CONTAINED IN THE PROPOSED SETTLEMENT AGREEMENT**

SEPTEMBER 27, 2004

STAFF ACKNOWLEDGMENT

The Staff Report on the Treatment of Competitive Issues and Certain PWEC Assets Contained in the Proposed Settlement Agreement of Arizona Public Service Company's Request for Rate Adjustment, Docket No. E-01345A-03-0437, was the responsibility of the Staff members listed below.

A handwritten signature in black ink, appearing to read "Matthew Rowell". The signature is fluid and cursive, with a large, sweeping initial "M".

Matthew Rowell
Chief Economist

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Introduction

On August 18, 2004, a proposed Settlement Agreement of Arizona Public Service Company's ("APS") pending rate case was docketed. That agreement contained proposed resolutions of issues regarding the treatment of Pinnacle West Energy Corporation's ("PWEC") Arizona generation assets. The agreement also contains several provisions that are pertinent to competition in the wholesale and retail electric markets in Arizona. The purpose of this Staff Report is to explain the provisions of the Settlement Agreement that deal with the PWEC assets and competitive issues.

PWEC Asset Treatment

Section II of the Settlement Agreement deals with the treatment of certain PWEC assets. The parties to the Settlement Agreement agreed that APS should be allowed to acquire and rate base the following PWEC generating units: West Phoenix CC-4, West Phoenix CC-5, Saguaro CT-3, Redhawk CC-1, and Redhawk CC-2 (collectively, the "PWEC Assets"). The capacity of each of these generating units is displayed in the following table:

Unit	Capacity in MW
West Phoenix CC-4	120
West Phoenix CC-5	500
Saguaro CT-3	100
Redhawk CC-1	530
Redhawk CC-2	530

The Track B competitive solicitation resulted in a contract between APS and PWEC for the purchase of a significant portion of this capacity during the summer months of 2003 through 2006. The rate basing of the above generating units will make this contract unnecessary. In order to recognize the ratepayer benefits associated with that contract, a portion of the value of the PWEC assets will be disallowed. Specifically, \$148 million of the PWEC Assets' value will be disallowed, which results in an original cost rate base value of \$700 million as of December 31, 2004.

APS has agreed that it will never seek recovery of "stranded costs" associated with any of the PWEC Assets.

FERC approval is necessary to transfer the PWEC Assets to APS. APS shall file a request for FERC approval within thirty days of the Commission approving the Settlement Agreement. Upon Commission approval of the Settlement Agreement, APS' rates will reflect the rate basing of the PWEC Assets. However, APS cannot actually acquire the PWEC Assets until FERC approval of the transfer is obtained. To bridge the time between the effective date of the rate increase and the actual date of the asset transfer, APS and PWEC will execute a cost-based purchased power agreement ("Bridge

PPA"). The Bridge PPA will be designed to represent the (non-fuel) costs of the PWEC Assets recovered in base rates per the Settlement Agreement. During the term of the Bridge PPA, APS will flow fuel costs (and off-system sales revenue) related to the PWEC Assets through the power supply adjustor ("PSA"). Any demand and non-fuel energy charges incurred under this Bridge PPA will be excluded from recovery under the PSA because they are already included in APS' base rates. The Bridge PPA shall remain in effect until FERC issues a final order approving the transfer of the PWEC assets to APS and the transfer is completed.

The parties believed it was appropriate to include provisions in the Agreement that deal with the possibility of FERC issuing an order that is in some way inconsistent with the Settlement Agreement. If FERC issues an order denying APS' request to transfer the PWEC Assets, the Agreement provides for the Bridge PPA to become a thirty-year PPA. Prices in this thirty-year PPA will reflect cost-of-service as if APS had acquired and rate-based the PWEC Assets at the value established in the Settlement Agreement. If FERC issues an order approving APS' request to acquire the PWEC Assets but at a value materially less than \$700 million, or if FERC issues an order approving the transfer of fewer than all of the PWEC Assets, or if FERC issues an order that is materially inconsistent with the Settlement Agreement, APS shall promptly file an appropriate application with the Commission so that rates may be adjusted. In these circumstances, the Bridge PPA shall continue at least until the conclusion of this subsequent proceeding to consider any appropriate adjustment to APS' rates.

The Commission Decision in APS' last financing case (Decision No. 65796) established a basis point credit that is to be paid by PWEC to APS. That basis point credit established in Decision No. 65796 will continue as long as the associated debt between APS and PWEC is outstanding. Credit for amounts deferred after December 31, 2004 shall be reflected in APS' next general rate proceeding.

The Parties agreed that West Phoenix CC-4 and West Phoenix CC-5 are "local generation" as that term is defined in the AISA protocol or any successor FERC-approved protocol. During must-run conditions, generation from the West Phoenix facility will be available at FERC-approved cost-of-service prices to electric service providers serving direct access load in the Phoenix load pocket.

\$234 Million Write-Off

Per Section VI of the Settlement Agreement, APS has agreed that it will not recover (now or in any subsequent proceeding) the \$234 million write-off attributable to Decision No. 61973, the Commission order that approved the 1999 APS Settlement Agreement.

Competitive Procurement of Power

Section IX of the Settlement Agreement includes provisions intended to enhance the prospects of the wholesale market in Arizona while still protecting retail customers. APS agrees that it will not pursue any self-build option having an in-service date prior to January 1, 2015, unless expressly authorized by the Commission. This provision does not prevent APS from purchasing a generation plant from a merchant or a utility. It also does not prevent APS from acquiring temporary generation needed for system reliability, distributed generation of less than fifty MW per location, and renewable resources. The up rating of APS generation is also allowed under this provision (not including the installation of new units.)

The Settlement Agreement does not relieve APS of its existing obligation to prudently acquire generating resources. If APS determines it is unable to fulfill that obligation without pursuing a self build option, APS will file an application with the Commission seeking authorization to self-build a generating resource(s).

Any application by APS for Commission authorization to self-build generation prior to 2015 will at a minimum address:

- a. APS' specific unmet needs for additional long-term resources.
- b. APS' efforts to secure adequate and reasonably priced long-term resources from the competitive wholesale market.
- c. The reasons why APS believes those efforts have been unsuccessful, either in whole or in part.
- d. The extent to which the self-build application is consistent with APS' resource plans and competitive resource acquisition rules or orders that may result from the Commission's resource planning workshops.
- e. Life cycle costs of the self-build option compared to that of available options available from the wholesale market.

The Settlement Agreement does not preclude APS from negotiating bilateral agreements with nonaffiliated parties.

APS will issue an RFP or other competitive solicitation(s) no later than the end of 2005 seeking long-term future resources of not less than 1000 MW for 2007 and beyond.

- a. "Long-term" resources means any acquisition of a generating facility or an interest in a generating facility, or any PPA having a term, including any extensions exercisable by APS on a unilateral basis, of five years or longer.
- b. Neither PWEC nor any other APS affiliate will participate in the 2005 solicitation.
- c. Regarding RFPs and solicitations after 2005, neither PWEC nor any other APS affiliate will participate without the appointment by the Commission or its Staff of an independent monitor.
- d. APS will not be obliged to accept any specific bid or combination of bids.
- e. All renewable resources, distributed generation, and DSM will be invited to

—compete in the 2005 RFP or other competitive solicitation and will be evaluated in a consistent manner with all other bids, including their life-cycle costs compared to alternatives of comparable duration and quality.

The Commission Staff has agreed to schedule workshops on resource planning issues that focus on developing needed infrastructure and developing a flexible, timely, and fair competitive procurement process. These workshops will also consider whether and to what extent the competitive procurement should include an appropriate consideration of a diverse portfolio of short, medium, and long-term purchased power, utility-owned generation, renewables, DSM, and distributed generation. The workshops will be open to all stakeholders and to the public. If necessary, the workshops may be followed with a rulemaking proceeding.

The Settlement Agreement allows APS to continue to use its Secondary Procurement Protocol except as modified by the express terms of this Agreement or unless the Commission authorizes otherwise.

Regulatory Issues

Section X of the Settlement Agreement contains provisions regarding certain regulatory issues. The Parties agreed that APS has the obligation to plan for and serve all customers in its certificated service area, irrespective of size. However, APS is to recognize, in its planning, the existence of any Commission direct access program and the potential for future direct access customers. These provisions do not prevent any Party from seeking to amend APS' obligation to serve at some time in the future.

The parties agreed that any changes in retail access will be addressed through the Electric Competition Advisory Group ("ECAG") or other similar process. One particular issue that will be addressed by the ECAG (or similar proceeding) is the resale by Affected Utilities of Revenue Cycle Services ("RCSs") to Electric Service Providers ("ESPs").

The Parties agreed that APS currently has the ability to self-build or buy new generation assets for native load, subject to the conditions in Section IX and X of the Settlement Agreement.

The Parties agreed that APS should be able to join a FERC-approved Regional Transmission Organization ("RTO") or an organization(s) performing the functions of an RTO. If the Settlement Agreement is approved, APS may participate in such organizations without further order or authorization from the Commission. The Agreement does not establish the ratemaking treatment for costs related to participation in an RTO.

The Settlement Agreement does not create or confirm an exclusive right for APS

to provide electric service within its certificated area, diminish any of APS' rights to serve customers within its certificated area, or prevent the Commission or any other governmental entity from amending the laws and regulations relative to public service corporations.

Staff's Position

While Staff was unpersuaded by the company's original argument for inclusion of the PWEC assets in rate base, Staff believes that the Settlement Agreement as a whole provides for a reasonable treatment of those assets. The Settlement Agreement as a whole mitigates the impact on rate payers associated with rate basing the PWEC assets and balances the potentially anti-competitive effects of rate basing with the pro-competitive provisions discussed above. The rate payer impact is mitigated because the assets are being added to the rate base at a value substantially less than their book value. Also, because the settlement provides for APS to drop its pending Track A related lawsuits against the Commission, rate payers will not face the risk of having to fund a \$234 million (or more) judgment in APS' favor. The Settlement Agreement provides for substantial commitments by APS to market based approaches to filling future capacity needs. The self build moratorium and RFP commitments outlined in Section IX of the Agreement will bolster the competitive alternatives available to APS. Taken as a whole Staff believes the Settlement Agreement strikes an appropriate balance between market and non-market approaches.

MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: September 27, 2004

RE: STAFF REPORT ON DEMAND-SIDE MANAGEMENT, RENEWABLES, AND
DISTRIBUTED GENERATION ISSUES CONTAINED IN THE PROPOSED
SETTLEMENT AGREEMENT OF ARIZONA PUBLIC SERVICE COMPANY'S
REQUEST FOR RATE ADJUSTMENT (DOCKET NO. E-01345A-03-0437)

Attached is the Staff Report on Demand-side Management, Renewables, and Distributed Generation Issues contained in the proposed settlement agreement of Arizona Public Service Company's request for rate adjustment. Staff recommends approval of the settlement agreement.

EGJ:BEK:rdp

Originator: Barbara Keene

Attachment: Original and thirteen copies

Service List for: Arizona Public Service Company
Docket No. E-01345A-03-0437)

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-03-0437

**DEMAND-SIDE MANAGEMENT, RENEWABLES, AND DISTRIBUTED
GENERATION ISSUES
CONTAINED IN THE PROPOSED SETTLEMENT AGREEMENT**

SEPTEMBER 2004

STAFF ACKNOWLEDGMENT

The Staff Report on Demand-side Management, Renewables, and Distributed Generation Issues Contained in the Proposed Settlement Agreement of Arizona Public Service Company's Request for Rate Adjustment, Docket No. E-01345A-03-0437, was the responsibility of the Staff member listed below.



Barbara Keene
Public Utilities Analyst

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Introduction

The proposed settlement agreement in the Arizona Public Service ("APS") rate proceeding (Docket No. E-01345A-03-0437) contains provisions regarding demand-side management ("DSM"), renewables, and distributed generation. These provisions are the result of settlement negotiations on a wide variety of issues in this case. As part of the overall settlement agreement, these provisions are in the public interest.

The settlement agreement is in the public interest because of the following:

- The agreement provides for APS to implement considerably more DSM than is being done today, resulting in customer savings, utility cost reductions, and reduced impact on the environment.
- The agreement provides safeguards to ensure that the level of DSM expenditures will be reasonable, including Commission approval of programs, unspent amounts in base rates being returned to customers, and APS filing semi-annual reports on its DSM programs.
- The agreement provides for expenditures for low income weatherization and bill assistance to more than double over test-year expenditures.
- The agreement places a high priority on energy-efficiency programs for schools, ultimately leading to savings for taxpayers.
- The agreement provides for the establishment of a collaborative DSM working group to provide APS with input on program development, implementation, and performance.
- The agreement changes the Environmental Portfolio Standard ("EPS") surcharge into an adjustment mechanism to allow for flexibility in funding the EPS if the Commission were to approve a funding change.
- The agreement provides for APS to issue a Request for Proposal in 2005 seeking renewable resources that should help provide further diversity to APS' generation portfolio.

Demand-side Management

Cost-effective DSM can meet the demand for electric energy services at a lower cost than purchasing or generating power. Reduced peak demand can delay the need for construction of new generation and transmission facilities. Reduced energy production may also lead to reduced air emissions from power plants and reduced consumption of water by generating unit cooling towers.

The settlement agreement provides for APS to spend \$10 million each year through base rates for DSM, plus another \$6 million per year through an adjustment mechanism. Although DSM spending could be phased in, APS would be obligated to spend at least \$48 million on DSM during calendar years 2005 - 2007. Of that amount, at least \$13 million would be spent during 2005, pending approval of the Final Plan discussed below. If APS does not spend the total \$30 million in base rate allowance during 2005 - 2007, the unspent amount would be credited to the account balance for the DSM adjustor (described below) in 2008. Eligible DSM expenditures would be energy-efficiency programs, a performance incentive for APS, and low income bill assistance. DSM spending over \$16 million per year could include demand response and additional energy efficiency programs.

Attached to the settlement agreement is a Preliminary Plan for eligible DSM-related items for calendar year 2005. The Preliminary Plan includes a listing and brief description of programs, program concepts, and program strategies and tactics. Within 120 days of Commission approval of the settlement agreement, APS would file a Final Plan for Commission approval. The Final Plan would include, at a minimum, program budgets and estimates of energy savings and load reductions.

The Preliminary Plan includes DSM programs for both residential and non-residential customers. At the top of the list is energy-efficient schools, under both new construction and retrofit of existing facilities.

APS would be allowed to recover a performance incentive based on a share of the net economic benefits resulting from energy-efficiency programs. The incentive would be capped at 10 percent of total DSM spending. The specific performance incentive would be included in the Final Plan.

Included in the \$10 million annual base rate allowance would be at least \$1 million for low income weatherization. Up to \$250,000 of the \$1 million could be used for bill assistance. The low income weatherization program helps low-income customers to have more energy-efficient homes by installing weather stripping and insulation; repairing ductwork; repairing roofs, windows, doors, ceilings, and floors; and adjusting, repairing, or replacing HVAC (heating, ventilation, and air conditioning) systems, evaporative coolers, and electric water heaters. The bill assistance portion of the program helps customers pay their electric bills. APS would file for Commission approval of the low income weatherization program within 60 days of the Commission's approval of the settlement agreement.

A DSM adjustment mechanism would be established for DSM expenditures above the \$10 million in base rates. The adjustor rate, initially set at zero, would be reset each March 1, beginning with March 1, 2006. A per-kWh charge for the year would be calculated by dividing the account balance by the number of kWh used by customers in the previous calendar year. General Service customers that are demand billed would pay a per kW charge instead of a per kWh charge. The DSM adjustor would be applied to both standard offer and direct access

customers. APS would combine the DSM adjustor and the EPS adjustor (to be discussed later in this report) as an "Environmental Benefits Surcharge" when billing residential customers. APS could combine the two adjustors when billing other customers.

Large customers whose single site usage is at least 20 MW and can demonstrate that their own DSM program is effective could file for Commission approval of an exemption from the DSM adjustor.

APS would file a plan of administration that describes how the DSM adjustor would operate.

Except for DSM programs that have already been approved, all DSM programs would be pre-approved by the Commission before APS could include their costs in any determination of total DSM costs incurred.

APS would file mid-year and end-year reports on its DSM programs.

APS would establish and maintain a collaborative DSM working group to provide APS with input on program development, implementation, and performance. At a minimum, Staff, the Residential Utility Consumer Office, Arizonans for Electric Choice and Competition, the Arizona State Energy Office, Western Resource Advocates, and Southwest Energy Efficiency Project would be invited to participate in the collaborate DSM working group.

APS would conduct a study to evaluate the merits of allowing large customers to self-direct DSM investments. The study would be filed within one year of Commission approval of the settlement agreement.

APS would conduct a study analyzing rate design modifications that could include, among others, mandatory time-of-use rates and expanded use of inclining block rates. A plan for the study would be presented to the collaborative DSM working group within 90 days of Commission approval of the settlement agreement. APS would submit the final results of the study to the Commission as part of its next general rate case application or within 15 months of Commission approval of the settlement agreement, whichever occurs first. APS would develop and propose to the Commission any appropriate rate design modifications that the study indicates would be reasonable, cost-effective, and practical.

Renewables

Increasing renewable energy could help to reduce reliance on conventional fuel sources such as natural gas. The settlement agreement addresses renewables issues in two ways: by addressing funding of the EPS and by establishing a special RFP.

Environmental Portfolio Standard

In regard to the EPS, APS would continue to recover \$6 million annually in base rates. The existing EPS surcharge, which provided \$6.5 million during the test year, would be converted into an adjustment mechanism to allow for Commission-approved changes to APS' EPS funding. Changes in funding could occur as a result of amendments to Rule 1618, or APS could apply to the Commission to increase EPS funding beyond that provided in base rates and the EPS surcharge. APS could not file such an application until one year after the termination of the EPS rulemaking docket. ~~Staff would initiate a rulemaking proceeding to modify Rule 1618 within 120 days of Commission approval of the settlement agreement.~~

The initial charge of the EPS adjustor would be the same as contained in the current EPS surcharge tariff, including caps. Any change in EPS funding requirements would be collected from APS customers in a manner that maintains the proportions between customer categories in the current EPS surcharge. The EPS adjustor would apply to both standard offer and direct access customers. The revenue collected from direct access customers would be made available to electric service providers. For billing purposes, the EPS adjustor could be combined with the DSM adjustor as discussed in the DSM section of this report.

Renewables programs directly involving APS' retail customers would be submitted to the Commission for approval. These programs would include those in which a rebate is given to retail customers.

Special RFP

APS would issue a special RFP in 2005 for at least 100 MW and 250,000 MWh per year of renewable energy resources for delivery beginning in 2006. Either in this solicitation or in subsequent procurements, APS would seek to acquire at least 10 percent of its annual incremental peak capacity needs from renewable resources.

Eligible resources would be solar, biomass/biogas, wind, small hydro (under 10 MW), hydrogen (other than from natural gas), and geothermal. These resources may be, but do not have to be, EPS-eligible. Resources need not provide firm capacity but must be deliverable to the APS system. The resources must be capable of providing at least 20,000 MWh of renewable energy annually, with a minimum of five years. Prices must be fixed or relatively stable and do not vary with either the price of natural gas or of electricity. Renewable resources must be no more costly than 125 percent of the market price of conventional resource alternatives. If APS does not receive sufficient in-state qualified bids, APS could acquire out-of-state resources to meet its 100 MW or 10 percent goals.

APS would circulate a draft of the RFP to potentially interested parties at least 30 days before issuing the RFP and conduct a meeting with potential bidders and interested parties at least 10 days before issuing the RFP.

If APS fails to acquire at least 100 MW of renewable resources pursuant to the RFP by December 31, 2006, APS would file a notice with the Commission by January 31, 2007, that describes the shortfall, explains the circumstances, and recommends actions.

Distributed Generation

In general terms, distributed generation (DG) is small-scale power generation units strategically located near consumers and load centers. DG has the potential to provide benefits to customers and support the economic operation of the power distribution grid.

In 1999, Staff formed a working group to investigate issues related to DG. The final report recommended that further workshops be held to acquire additional information for several issues. The settlement agreement provides for Staff to schedule workshops to consider outstanding issues concerning DG. The workshops may be followed by rulemaking.

MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: September 27, 2004

RE: STAFF REPORT ON ADJUSTMENT MECHANISMS CONTAINED IN THE
PROPOSED SETTLEMENT AGREEMENT OF ARIZONA PUBLIC SERVICE
COMPANY'S REQUEST FOR RATE ADJUSTMENT (DOCKET NO. E-01345A-
03-0437)

Attached is the Staff Report on Adjustment Mechanisms contained in the proposed settlement agreement of Arizona Public Service Company's request for rate adjustment. Staff recommends approval of the settlement agreement.

EGJ:RGG/BEK:rdp

Originator: Robert Gray and Barbara Keene

Attachment: Original and thirteen copies

Service List for: Arizona Public Service Company
Docket No. E-01345A-03-0437)

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-03-0437

**ADJUSTMENT MECHANISMS
CONTAINED IN THE PROPOSED SETTLEMENT AGREEMENT**

SEPTEMBER 2004

STAFF ACKNOWLEDGMENT

The Staff Report on Adjustment Mechanisms Contained in the Proposed Settlement Agreement of Arizona Public Service Company's Request for Rate Adjustment, Docket No. E-01345A-03-0437, was the responsibility of the Staff members listed below.

A handwritten signature in cursive script, appearing to read "Robert Gray".

Robert Gray
Public Utilities Analyst

A handwritten signature in cursive script, appearing to read "Barbara Keene".

Barbara Keene
Public Utilities Analyst

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Introduction

The proposed settlement agreement in the Arizona Public Service ("APS") rate proceeding (Docket No. E-01345A-03-0437) contains provisions for implementing various adjustment mechanisms. These include the Power Supply Adjustor ("PSA"), the Demand Side Management ("DSM") Adjustor, the Environmental Portfolio Standard ("EPS") Adjustor, the Competitive Rules Compliance Charge ("CRCC"), the Returning Customer Direct Access Charge ("RCDAC"), and the Transmission Cost Adjustor ("TCA"). The DSM Adjustor and EPS Adjustor are discussed in the Staff Report on Demand-side Management, Renewables, and Distributed Generation.

The structure and features of the adjustors discussed in this report are the result of settlement negotiations on a wide variety of issues in this case. Staff believes that the PSA, through a variety of provisions, reasonably balances the interests of ratepayers and APS while providing a measure of both certainty and flexibility in the future treatment of the PSA. As part of the overall settlement agreement, the adjustor mechanisms are in the public interest.

Power Supply Adjustor

APS does not currently have a PSA, so there is no provision for variation in fuel and purchased power costs between rate cases. The proposed PSA provides for the tracking of changes in purchased power and fuel costs. Initially, the adjustor rate would be set at zero. The adjustor rate would be reset annually beginning with the first April billing cycle each year, starting in 2006. Each year, APS would file a publicly available report by March 1st, documenting how the new adjustor rate was calculated. The Commission and other interested parties would have the opportunity to review the calculation of the new adjustor rate before it is applied to customer bills. The base cost of fuel and purchased power would be set at \$0.020743 per kWh, to be included in APS' base rates.

The entirety of each year's over or under collection would be subject to a sharing mechanism where APS receives a 10 percent share and ratepayers receive a 90 percent share, the net effect of which is that APS would be at risk for 10 percent of each year's under recovery and would receive the benefit of 10 percent of each year's over recovery. This sharing mechanism provides APS with an incentive to reduce the cost of its purchased power and fuel at all times and allows ratepayers to share in those savings.

A bandwidth of \$0.004 per kWh would limit the amount the adjustor rate could change from one year to the next. This bandwidth would limit the amount of annual rate change APS customers would see from fuel and purchased power costs, absent specific Commission action. Any remaining over or under collection would be carried over in a balancing account, the contents of which would not be subject to the 90/10 sharing provision in future years. The balancing account would accrue interest based on the one-year nominal Treasury constant maturities rate. Accrual of interest could benefit APS or APS ratepayers, depending on whether the balancing account is over or under-collected.

When the balancing account reaches either a positive or negative \$50 million level, APS would have 45 days to file for Commission approval of a surcharge/credit to address the under/over recovery. If APS does not wish to address this balance, it must file a report explaining why action is not necessary. Commission action would be required to establish or change a surcharge created pursuant to this provision. The Commission and its Staff may review the prudence of fuel and purchased power costs and the adjustor calculations at any time. Any costs flowed through the adjustor are subject to refund if they are later found by the Commission to be imprudent.

The life of the PSA would be at least five years from the date the rates resulting from this proceeding go into effect. Within four years of the date the PSA is implemented, APS would file a report, with supporting testimony, regarding its experience with the PSA and recommending whether the PSA should remain in effect. The Commission would consider continuation of the PSA after APS has filed this report, or during its next rate case, whichever comes first. Whether in a future APS rate case or in a review of APS' PSA report, any action to abolish the PSA would not take effect until the five-year period had expired. If the Commission decides to retain the PSA such that it extends beyond the initial five-year period, the Commission may later abolish the PSA at any time, including outside a rate proceeding, subject to the applicable procedural requirements. If the Commission abolishes the PSA, the Commission would address any existing under/over recovery existing at the time of termination. The Commission may also adjust APS' base rates to reflect the costs of fuel and purchased power. These provisions provide the Commission with flexibility in considering whether the PSA should be continued in the future and, if so, in what form.

The settlement agreement requires APS to file on-going monthly reports of PSA-related activity. One report, publicly available, would be provided to Staff and the Residential Utility Consumer Office and would include bank balance calculations, power and fuel costs, customer sales, customer numbers, items excluded from the PSA calculations, adjustments to the PSA calculations, off-system sales margins, system losses, monthly maximum retail demand, and a contact person. A second, confidential, report would be provided to Staff, with detailed information on generating units, power purchases, and fuel purchases. Both reports would be due on the first day of the third month after the end of the month which the report covers. An APS officer would certify under oath that the information contained in the public and confidential reports is true and accurate to the best of her or his information and belief. Additionally, APS would provide the information to be contained in these reports for the base cost of fuel and purchased power costs during the test year, as included in the settlement. These reporting requirements will provide the Commission with a variety of on-going information for use in monitoring APS' purchased power and fuel procurement activities and other matters.

Other provisions of the PSA include ratepayers retaining the benefits of all APS off-system sales, subject to the 90/10 sharing provision and the \$0.004 bandwidth provision. Such off-system sales benefits will reduce the overall cost of fuel and purchased power for ratepayers. The PSA would also allow for recovery of the prudent direct costs of hedging contracts for fuel

and purchased power, providing APS with flexibility in hedging its fuel and purchased power costs. The PSA would not apply to direct access customers or customers served under Rates E-36, SP-1, Solar-1, and Solar-2. As part of APS' tariff compliance filing, the Company would file a plan of administration, detailing how the PSA would operate.

Competitive Rules Compliance Charge

The CRCC is a charge which would enable APS to recover costs related to the transition to retail competition. The settlement agreement includes approximately \$8 million in the test year for this charge, and APS may recover a maximum of \$47.7 million plus interest through a charge of \$0.000338 per kWh over a five-year collection period. The CRCC would terminate immediately once this amount is recovered. If a balance remains at the end of the five-year period, APS would file an application with the Commission to adjust the CRCC to recover the remaining balance.

The CRCC would be a separate surcharge, i.e., it would not be included in base rates. All customers would pay the CRCC, except for those served on rate schedules Solar-1 or Solar-2. As part of APS' tariff compliance filing, the Company would file a plan of administration, detailing how the CRCC would operate.

Returning Customer Direct Access Charge

The RCDAC would apply to customers who return to standard offer service from direct access service and would be calculated separately for each customer. The RCDAC would address the additional one-time and recurring costs incurred by APS to provide standard offer service to returning customers, which otherwise would be imposed on other standard offer customers. The RCDAC would apply only to customers or aggregated groups with a load of 3 MW or greater and only if the customer or group does not provide APS with a one-year notice of intent to take standard offer service. The RCDAC rate schedule would identify and define the components of the charge as well as a general framework of how the charge would be calculated. The RCDAC would not last longer than 12 months for any individual customer. As part of APS' tariff compliance filing, the Company would file a plan of administration, detailing how the RCDAC would operate.

Transmission Cost Adjustor

The TCA is an adjustor which would be established to ensure that standard offer customers and direct access customers pay the same transmission costs. The TCA would apply only to costs related to changes in APS' open access transmission tariff ("OATT") or the tariff of a regional transmission organization ("RTO") or similar organization. The TCA would not go into effect until APS' transmission component of retail rates exceeds the test year base of \$0.000476 per kWh by five percent. APS may then file with the Commission for approval of a TCA rate. When APS files with FERC to change its transmission rates, it would file a notice of such application with the Commission and provide a copy of the application to the Director of

the Utilities Division. As part of APS' tariff compliance filing, the Company would file a plan of administration, detailing how the TCA would operate.

Staff Position

The implementation of an adjustor mechanism such as the PSA entails a wide range of considerations which must be weighed carefully to ensure that such a mechanism is in the public interest. Adjustor mechanisms by their nature attempt to balance a variety of possible goals, such as certainty, flexibility, price stability, sending a price signal as prices change, and providing a reasonable opportunity to recover prudently incurred costs. The PSA contained in the proposed settlement agreement contains a variety of provisions which addresses both the interests of ratepayers and APS in a reasonable fashion. While no adjustor mechanism can fully protect ratepayers from the underlying volatility of energy markets, the proposed PSA helps shield ratepayers from price volatility through the provision of regular adjustments of the adjustor rate, the inclusion of a bandwidth limiting the amount of automatic adjustment in the adjustor rate, and the provision of the opportunity for cost recovery of the costs of hedging fuel and purchased power costs. Further, APS is motivated to minimize the cost of fuel and purchased power through the 90/10 sharing mechanism.

The five year life of the PSA and related provisions protect the public interest by providing the opportunity to review the PSA mechanism in the future for possible modification or termination while also providing APS with a level of certainty regarding the method of cost recovery for its substantial fuel and purchased power costs. Such flexibility is important given the new nature of the proposed PSA and the uncertainty regarding what future conditions will be in the electricity industry.

The settlement contains strong safeguards which enable the Commission to review costs which APS would be passing through to its customers via the PSA. The settlement provides a commitment by APS to provide a wide variety of information related to the operation of the PSA on a monthly basis, which will assist the Commission and other interested parties in monitoring and assessing the operation of the PSA. Additionally, the settlement agreement specifically recognizes that the Commission can review the prudence of fuel and purchased power costs at any time. In summary, Staff believes the adjustor provisions contained in the proposed settlement agreement are in the public interest, as they reasonably balance the interests of ratepayers and APS and provide a variety of incentives to the Company to manage the PSA in a manner which is beneficial to its ratepayers while also providing the opportunity to address any problems which may arise in the future operations of the PSA.

MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: September 27, 2004

RE: STAFF REPORT ON RATE DESIGN, LOW INCOME PROGRAMS, AND
SERVICE SCHEDULES CONTAINED IN THE PROPOSED SETTLEMENT
AGREEMENT OF ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR
RATE ADJUSTMENT (DOCKET NO. E-01345A-03-0437)

Attached is the Staff Report on Rate Design, Low Income Programs, and Service Schedules contained in the proposed settlement agreement of Arizona Public Service Company's request for rate adjustment. Staff recommends approval of the settlement agreement.

EGJ:EAA:BEK:rdp

Originator: Erinn Andreasen and Barbara Keene

Attachment: Original and thirteen copies

Service List for: Arizona Public Service Company
Docket No. E-01345A-03-0437)

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-03-0437

**RATE DESIGN, LOW INCOME PROGRAMS AND, SERVICE SCHEDULES
CONTAINED IN THE PROPOSED SETTLEMENT AGREEMENT**

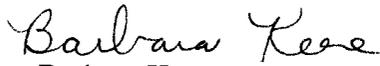
SEPTEMBER 27, 2004

STAFF ACKNOWLEDGMENT

The Staff Report on Rate Design, Low Income Programs, and Service Schedules Contained in the Proposed Settlement Agreement of Arizona Public Service Company's Request for Rate Adjustment, Docket No. E-01345A-03-0437, was the responsibility of the Staff members listed below.



Erinn Andreasen
Public Utilities Analyst
Rate Design



Barbara Keene
Public Utilities Analyst
Low Income Programs and Service Schedules

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Introduction

On August 18, 2004, a proposed settlement agreement of Arizona Public Service Company's ("APS") pending rate case was docketed. The proposed agreement addresses certain rate design, service schedule, and low income provisions. These provisions are the result of settlement negotiations on a wide variety of issues in this case. As part of the overall settlement agreement, these provisions are in the public interest.

Overall Increase

The proposed settlement agreement would allow APS to recover an additional \$67.5 million in base revenues. The base revenue increase reflects a system average increase of 3.77 percent.

Principles that Influenced Rate Design

One of the principles considered in the settlement process is to adopt rates that reflect cost or movement toward cost. Moving toward cost promotes efficient cost recovery and customer equity by reducing subsidizations among customer classes. With that goal in mind, the rates and provisions adopted by the settlement generally reflect certain cost of service considerations.

While cost of service was an important factor in setting rates, other factors were also considered in the process. These factors include; rate continuity for the customer, adopting rate structures that promote conservation, designing rates that are transparent in nature to promote customer understandability, and the reduction of duplicative and underperforming rate structures.

Rate Unbundling

Under the provisions adopted in the settlement agreement, unbundled rates would be adopted for most rate schedules and cost-based unbundling would be permitted. Unbundling standard offer rates and pricing certain competitive service rate elements to reflect cost enhance the opportunity for retail access in APS' service territory by providing ratepayers with the price signals they need to make informed decisions about shopping for competitive services.

The residential rate design reflects cost-based unbundling of distribution and revenue cycle services. The general service rate design reflects cost-based unbundling of generation and revenue cycle services. With regard to E-32, E-34, and E-35, the revenue requirement was allocated to establish first the unbundled component of generation at cost and then the unbundled component of revenue cycle services.

Residential Rates

Under the proposed settlement agreement, the residential rate class would generate an additional 3.94 percent in revenues from base rates. The residential class as a whole would

receive an increase that is only slightly more than the system average increase. The following table summarizes the residential revenue increases by rate schedule as proposed by the settlement agreement.

Residential Rate Schedules		
Rate Designation	Description	Proposed Revenue Increase
E-10	Classic Rate	4.82%
E-12	Standard Rate	3.80%
ET-1	Time-of-Use	3.80%
EC-1	Service with Demand Charge	4.82%
ECT-1R	Time-of-Use with Demand Charge	3.80%

In order to avoid the potential for disproportionate rate impacts to customers, the current residential rate structures, such as the number and size of rate blocks and the time-of-use periods, would be retained.

In order to mitigate the rate impacts of eliminating schedules at the time of the next rate case, rates E-10 and EC-1 would receive a slightly higher increase than the other residential rate schedules. To provide a period for phase out, Schedule E-10 and EC-1 would remain frozen and not be eliminated in this proceeding. However, these rate schedules would be eliminated in APS' next rate proceeding. In order to provide customers with notice of intent to cancel these rate schedules, APS would provide a Staff-approved notice to customers on E-10 and EC-1 at the conclusion of this proceeding and at the time APS files its next rate case.

Residential Time-of-Use

APS would maintain its current on-and-off peak rates for the winter billing period. In response to the concern for flexibility in implementing changes to certain time-of-use provisions, within 180 days of a decision in this matter, APS would submit a study to Staff that would examine the ways in which APS can implement flexibility in changing on- and off-peak time periods and other time-of-use characteristics. APS would also consult with Staff prior to designing its study to ensure that the study addresses all relevant issues. Time-of-use issues would specifically be addressed in APS' next rate case.

In order to enhance time-of-use options for residential customers, experimental time-of-use periods for ET-1 and ECT-1R would be adopted. The experimental periods would provide a limited number of customers with the option of selecting alternative on-peak time periods of 7:00 a.m. to 7:00 p.m. or 8:00 a.m. to 8:00 p.m. The experimental program would be limited to a maximum of 10,000 customers due to the costs associated with the implementation of the program. APS would be required to submit annual reports to Staff evaluating the outcomes of the program and making a recommendation regarding the continuation of the program.

General Service and Classified Rates

Under the proposed settlement agreement, revenues from E-32, E-32R, E-34, E-35, E-53, E-54, and general service contracts would generate an additional 3.5 percent in revenues from base rates. The following table summarizes the revenue increase to general service and classified rate schedules proposed by the settlement agreement.

General Service Rate Schedules		
Rate Designation	Description	Proposed Revenue Increase
E-21	Frozen Time-of-Use, Small less than 100 kW	5%
E-22, E-23, E-24	Time-of-Use, Small, Medium, and Large	5%
E-30	Extra Small Unmetered	5%
E-32, E-32R	General Service and Partial Requirements Rider	3.5%
E-34, E-35	Extra Large and Extra Large Time-of-Use	3.5%
E-53	Athletic Stadiums and Sports Fields	3.5%
E-54	Seasonal Service	3.5%
	Special Contracts	3.5%

Classified Rate Schedules		
Rate Designation	Description	Proposed Revenue Increase
E-20	Time-of-Use Religious Houses of Worship	5%
E-38, E-38T	Frozen Agricultural Irrigation Service and Time-of-Use option	5%
E-40	Agricultural Wind Machine Service	5%
E-47	Dusk to Dawn Lighting Service	5%
E-51	Frozen Cogeneration and Small Power Production Under 100 kW	5%
E-58	Street Lighting Service	5%
E-59	Government Owned Street Lighting Systems	5%
E-67	Municipal Lighting Service, City of Phoenix	5%
E-221, E-221-8T	Water Pumping Service and Time-of-Use Option	5%

The majority of APS' general service customers are served on rate schedule E-32, and customers on this rate have diverse usage characteristics. Due to the complexity of the current rate, schedule E-32 would be modified in an effort to simplify its design and improve customer understandability. When designing the rate, consideration was given to smoothing out the rate impacts across customers of varying sizes. Changes include the addition of an energy block for customers with loads under 20 kW and the addition of a demand billing block for customers with loads greater than 100 kW.

To provide a period for phase out, frozen rates E-38 and E-38T would not be eliminated in this proceeding. However, these rate schedules would be eliminated in APS' next rate proceeding. In order to provide customers with notice of intent to cancel these rate schedules, APS would provide a Staff-approved notice to customers on these schedules at the conclusion of this proceeding and at the time APS files its next rate case.

Under the proposed settlement agreement, the changes to the rate structure for lighting tariffs E-47 and E-58 proposed in APS' application would be adopted. These changes allow for a greater menu of options available to lighting customers.

General Service Time-of-Use

The existing 11:00 a.m. to 9:00 p.m. on-peak time periods would remain in effect for general service time-of-use customers, and the summer rate period would begin in May and conclude in October.

APS' current time-of-use rate schedule, E-20, would be frozen. To provide a period for phase out, experimental time-of-use schedules E-22, E-23, and E-24, which are all limited by caps on customer participation, would be frozen. Experimental time-of-use schedule E-21, which had previously been frozen, and E-22, E-23, and E-24 would be eliminated in APS' next rate proceeding. In order to provide customers with notice of intent to cancel E-21, E-22, E-23, and E-24, APS would provide a Staff-approved notice to customers on these schedules at the conclusion of this proceeding and at the time APS files its next rate case.

Under the proposed settlement agreement, a new rate schedule, E-32 TOU, would be adopted to provide general service customers with an additional time-of-use rate.

Voltage Discounts

The settlement adopts transmission and primary voltage discounts for certain general service rates. Customers that take service at transmission and primary voltage levels require less utility funded facilities and equipment. Under the proposed settlement, military base customers that are served directly from APS substations would receive an additional primary service discount of \$2.74 per kW due to certain cost of service considerations.

Compliance

As part of APS' compliance filing in this matter, APS would be required to meet and confer with Commission Staff to review APS' rate schedules for consistency with the provisions adopted by the proposed settlement agreement.

Low Income Programs

The settlement agreement provides for expansion of the low income weatherization program, including bill assistance, as discussed in the Staff Report on Demand-side Management, Renewables, and Distributed Generation issues.

It was the intention of the parties to this case that low income customers be insulated from the rate increase proposed in the settlement agreement. Therefore, the discount levels were increased for both the E-3 and E-4 tariffs. In addition, APS would increase its annual funding for marketing its E-3 and E-4 tariffs to \$150,000.

Service Schedules

Attached to the settlement agreement are revised versions of Schedules 1, 3, 4, 7, 10, and 15. The proposed changes to each schedule are described below.

Schedule 1 - Terms and Conditions for Standard Offer and Direct Access Services

Schedule 1, contains charges for various services. The settlement agreement proposes to change these charges to be primarily cost-based. The revised charges are summarized in the following table:

Description (Schedule 1 Section)	Current Charge	Proposed Charge
trip charge (2.2.1)	none	\$16.00
after-hour service establishment (2.2.2)	\$50	\$75.00
after-hour other services (2.2.3)	none	\$75.00
overhead reconnection (4.5.1)	\$87.50	\$96.50
underground reconnection (4.5.1)	\$125.00	\$115.00
on-site energy evaluation (4.6)	\$50.00	\$82.00
joint site meeting (6.2.3)	\$30.00 metro area \$75.00 outside metro \$30/hr after 30 minutes	\$62.00 all areas \$53/hr after 30 minutes
reread charge (6.4.4 and 6.4.5)	\$10.00	\$16.50
meter test (6.5)	\$25.00	\$30.00 meter shop \$50.00 field

Other changes to Schedule 1 include adding a provision for electronic bills, adding provisions regarding enforcement of meter access requirements, clarifying language regarding power factor requirements, and making editorial changes.

Schedule 3 - Conditions Governing Extensions of Electric Distribution Lines and Services

The settlement agreement proposes modifications to Schedule 3 that include the following:

1. For extensions with construction costs not exceeding \$25,000, the extension is provided for free if "two times the customer's expected annual revenue" is more than the cost of the extension. To make no distinction between Standard Offer and Direct Access customers, the calculation would be changed to use "six times the customer's expected annual distribution revenue."
2. The economic feasibility analysis for extensions with construction costs exceeding \$25,000 examines the return on investment for a particular extension. The extension is free if the extension is determined to be economically feasible. The calculation would be changed to use only distribution revenue.
3. In calculating the economic feasibility of real estate developments, the methodology would be changed to use only distribution revenue and to estimate sales volume by not assuming that all residential customers in a development are all-electric.
4. Currently, irrigation pumping customers advance the total construction cost of extensions. This provision would be changed so that non-agricultural irrigation pumping extensions would be handled in the same manner as other non-residential customers.
5. Language specific to customers served on network distribution systems would be deleted.
6. Language would be added to provide for a customer contribution when the customer requests an additional primary feeder.
7. Language would be added to allow customers to design and construct facilities.

Schedule 4 - Totalized Metering of Multiple Service Entrance Sections at a Single Site for Standard Offer and Direct Access Service

The settlement agreement proposes to change Schedule 4 to make totalizing of meter readings available to residential customers and single-phase commercial customers, to allow customers to request that meters no longer be totalized, and to make editorial changes.

Schedule 7 - Electric Meter Testing and Maintenance Plan

The settlement agreement proposes to change Schedule 7 by adding language for performance monitoring of solid-state meters and by making editorial changes.

Schedule 10 - Terms and Conditions for Direct Access

The settlement agreement proposes to make editorial changes to Schedule 10.

Schedule 15 - Conditions Governing the Provision of Specialized Metering

The settlement agreement proposes to change Schedule 15 by modifying the schedule title to be applicable to additional technology, by better defining cost responsibility, by addressing technical aspects of meter installations, and by making editorial changes.

Public Interest

Staff believes that the provisions regarding rate design and service charges are in the public interest for the following reasons.

- The provisions in the settlement adopt rates and charges that generally move toward cost while minimizing the potential for adverse rate impacts. Moving toward cost for promotes efficient cost recovery and customer equity by reducing subsidizations among customer classes.
- Under the settlement, the opportunity for retail access in APS' service territory is enhanced through the unbundling of standard offer rates and the pricing of certain competitive service rate elements to reflect cost. Such cost based competitive service rate elements will provide ratepayers with the price signals they need to make informed decisions about shopping for competitive services.
- In order to mitigate the potential for disproportionate impacts to customer bills, the current residential rate structures including rate blocks and time-of-use provisions are maintained.
- The settlement promotes efficiency through the phasing out of duplicative and underperforming rate structures.
- In order to address concerns regarding APS' ability to change its on- and off-peak time periods to be more reflective of times of actual system peak, APS would conduct a study to evaluate ways in which it can implement more flexibility. In order for a thorough examination, time-of-use issues would be reexamined in APS' next rate case.
- The settlement enhances time-of-use options through the adoption of experimental on-peak periods for residential time-of-use customers and the adoption of a new general service time-of-use rate, E-32 TOU.
- General service rate schedule E-32 has been redesigned in an effort to simplify the current rate and improve customer understandability. In designing the rate, consideration

was given not only to cost, but also to smoothing out the rate impact to customers of varying sizes.

- Qualifying low income customers will benefit from an increase in the available low-income discount.