



BEFORE THE ARIZONA CORPORATION COMMISSION

- 2 MARC SPITZER
CHAIRMAN
- 3 WILLIAM A. MUNDELL
COMMISSIONER
- 4 JEFF HATCH-MILLER
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COMMISSIONER

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7 IN THE MATTER OF THE APPLICATION
 8 OF ARIZONA PUBLIC SERVICE
 9 COMPANY FOR A HEARING TO
 10 DETERMINE THE FAIR VALUE OF THE
 11 UTILITY PROPERTY OF THE COMPANY
 12 FOR RATEMAKING PURPOSES, TO FIX
 13 A JUST AND REASONABLE RATE OF
 14 RETURN THEREON, TO APPROVE RATE
 15 SCHEDULES DESIGNED TO DEVELOP
 16 SUCH RETURN, AND FOR APPROVAL
 17 OF PURCHASED POWER CONTRACT.

Docket No. E-01345A-03-0437

Arizona Corporation Commission
DOCKETED
 SEP 27 2004

DOCKETED BY	
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NOTICE OF FILING

15 The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the
 16 Direct Testimonies of Marylee Diaz Cortez and Stephen Ahearn in the above-referenced
 17 matter.

RESPECTFULLY SUBMITTED this 27th day of September, 2004.

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3 of September, 2004 with:

3 Docket Control
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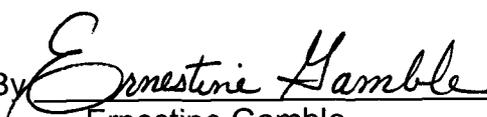
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By 
Ernestine Gamble
Secretary to Scott Wakefield

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

DOCKET NO. E-01345A-03-0437

DIRECT TESTIMONY

of

MARYLEE DIAZ CORTEZ

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

September 27, 2004

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1 **INTRODUCTION**

2 Q. Please state your name for the record.

3 A. My name is Marylee Diaz Cortez.

4

5 Q. Have you previously testimony in this docket?

6 A. Yes. I filed direct testimony in this docket on February 3, 2004. My
7 testimony addressed RUCO's recommended revenue requirement.

8

9 Q. What is the purpose of your additional testimony?

10 A. The purpose of this additional testimony is to support a settlement that the
11 majority of the parties to this docket have recently negotiated and to
12 recommend that the Commission adopt the settlement. Specifically, my
13 testimony will address the settlement as it pertains to the agreed upon
14 revenue requirement, rate adjustor mechanisms, and rate design. Mr.
15 Stephen Ahearn will address the policy issues, including Demand Side
16 Management, the PWEC assets, and competitive issues.

17

18 **REVENUE REQUIREMENT**

19 Q. What revenue requirement is included in the settlement agreement?

20 A. The parties have agreed on a revenue requirement of \$1,867,084,000,
21 which represents a 3.77% increase over the 2002 test year adjusted
22 revenue.

23

1 Q. How does this compare with the revenue requirement requested in APS's
2 application?

3 A. APS's application proposed a revenue requirement of \$1,966,674,000,
4 which represents a 9.77% increase over 2002 test year adjusted revenue.

5
6 Q. How does the settlement revenue requirement compare with the revenue
7 requirement recommended by RUCO in its direct testimony?

8 A. RUCO recommended a revenue requirement of \$1,831,515,000
9 (including Miscellaneous revenues). This represented a 2.84% decrease
10 from 2002 test year adjusted revenues.

11
12 Q. How is it that RUCO is willing to settle on a 3.77% *increase* when it
13 originally recommended a 2.84% *decrease*?

14 A. RUCO's original revenue requirement recommendation was comprised of
15 two phases. Phase I of the proceeding was to resolve all rate case issues
16 excepting the PWEC assets and expenses. The 2.84% decrease was
17 applicable to Phase I and did not contemplate any additional energy and
18 capacity costs. RUCO recommended a Phase II portion of the docket,
19 which was to take place after a least cost process was conducted on
20 APS's energy and capacity requirements. During Phase II any additional
21 revenue requirement applicable to energy and capacity would be included
22 in rates. Thus, the 2.84% decrease was applicable only to Phase I, which
23 did not contemplate any additional capacity. RUCO always anticipated

1 that the Phase II energy and capacity determination would create
2 additional revenue requirement. Thus, the settlement revenue
3 requirement, which resolves all issues, is not comparable to RUCO's
4 proposed decrease, which does not include the revenue requirement
5 associated with additional capacity and energy.

6
7 Q. Does RUCO believe the settlement agreement revenue requirement is fair
8 and reasonable?

9 A. Yes.

10
11 Q. What is the basis of RUCO's conclusion that the 3.77% rate increase is
12 fair and reasonable?

13 A. RUCO's analysis of a fair and reasonable settlement revenue requirement
14 began with our original recommended revenue requirement. We then
15 assessed and estimated what the Phase II energy and capacity analysis
16 might have yielded and factored in our perception of litigation risk. The
17 revenue requirement ultimately included in the settlement agreement is
18 consistent with our estimates.

19
20 Q. Did the parties reach agreement on each and every ratemaking element
21 that comprises the agreed upon 3.77%?

22 A. No, nor was it even intended that we would reach resolution at that level.
23 RUCO determined the 3.77% increase using its own analysis and

1 assumptions, as did each the parties. Thus, while all signatories support
2 the agreed upon revenue requirement, each signatory will have a
3 somewhat different view of the make-up of the 3.77% increase. In large
4 part this approach was one of the reasons the parties, despite very
5 divergent points of view, were able to agree upon a revenue requirement.

6
7 **RATE ADJUSTORS**

8 Q. Do the terms of the settlement agreement include any rate adjustor
9 mechanisms or surcharges?

10 A. Yes. The settlement agreement includes the continuation of the existing
11 EPS surcharge and a new Competitive Rules Compliance Charge (CRCC)
12 designed to recover competitive transition costs over a five year period, at
13 which time the surcharge will cease. Three rate adjustors are included in
14 the settlement agreement; a Power Supply Adjustor (PSA), a
15 Transmission Cost adjustor, and a DSM adjustor.

16
17 Q. In direct testimony did RUCO support these adjustor mechanisms?

18 A. No. RUCO's direct position did not include rate basing of the PWEC
19 assets. Without the PWEC assets, APS's fuel mix was more heavily
20 weighted with coal and nuclear, the cost of which is not currently volatile
21 or widely fluctuating. Thus, under those circumstances, RUCO did not
22 believe the proposed PSA would fit certain criteria for rate adjustment
23 mechanisms, nor did RUCO find that it was even necessary. However,

1 with the inclusion of the PWEC assets, a significant portion of APS's fuel
2 mix is natural gas, which does meet the volatility test in my direct
3 testimony.

4
5 RUCO's direct position supported the inclusion of additional DSM funding
6 in base rates. As a compromise in the settlement agreement RUCO has
7 agreed to partial base rate funding and partial adjustor funding for DSM.
8 Likewise, RUCO's agreement for a Transmission adjustor represents a
9 trade-off made in the interest of a comprehensive settlement agreement.

10
11 **RATE DESIGN**

12 Q. Please describe the settlement agreement's allocation of the of the 3.77%
13 rate increase.

14 A. Under the terms of the settlement agreement, the 3.77% rate increase will
15 be allocated among the customer classes as follows:

16	*	Residential	3.94%
17	*	General Service	3.50%
18	*	Irrigation	5.00%
19	*	Lighting	5.00%

20
21 Q. Does this rate allocation represent a compromise on RUCO's part?

22 A. Yes. In direct testimony RUCO advocated an even across-the-board
23 allocation of the revenue requirement, whereby each customer class

1 would be allocated the same percentage increase or decrease as was
2 ultimately adopted. The settlement agreement allocation represents a
3 compromise on RUCO's part, made to facilitate a settlement that RUCO
4 believes to be fair on an overall basis. Further, in return for this
5 compromise allocation of the rate increase RUCO was able to achieve
6 some of its other rate design goals. This included the preservation of
7 Schedule E-10 and EC-1 rates (which APS was proposing to eliminate).
8 The elimination of these rates would have had disproportional impacts on
9 the residential customers on these rate schedules. The settlement rate
10 design also accomplishes an even allocation of the increase over the
11 individual residential rate schedules, as well as preserves time-of-use
12 peak and off peak periods.

13
14 **CONCLUSION**

15 Q. What are your concluding remarks regarding the settlement agreement?

16 A. The settlement agreement reaches a fair and reasonable result for all
17 parties. This was no small accomplishment in light of the numerous
18 issues in this case and diverse interests of the parties. The settlement
19 agreement also resolves issues that reach far beyond revenue
20 requirements and rate design, and provides a platform for APS to move
21 forward under a new regulatory format that embraces wholesale
22 competition and at the same time leaves intact the safeguards of
23 regulation.

1 Q. Does this conclude your testimony in support of the settlement
2 agreement?

3 A. Yes.

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POWER CONTRACT.**

DOCKET NO. E-01345A-03-0437

DIRECT TESTIMONY

of

STEPHEN AHEARN

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

September 27, 2004

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1 **INTRODUCTION**

2 Q. Please state your name and business address for the record.

3 A. My name is Stephen Ahearn. My business address is 1110 West
4 Washington, Suite 220, Phoenix, Arizona 85007.

5
6 Q. Please state your educational background and qualifications in the utility
7 regulation field.

8 A. I have been employed by the state of Arizona as the Director of the
9 Residential Utility Consumer Office ("RUCO") since January 2003. From
10 1998 through 1999, I was employed at the Arizona Corporation
11 Commission in the capacity of Executive Consultant. From 1990 to 1998,
12 I was actively involved with utility regulation at the Commission and utility
13 policy-making at the Legislature in my role as the Manager of Planning
14 and Policy at the Department of Commerce Energy Office. Additionally, I
15 have had training in utility ratemaking and telecommunications policy
16 conducted by NARUC and New Mexico State University, respectively.
17 Finally, I have an MBA in Finance from UCLA

18
19 Q. What is the purpose of your testimony?

20 A. My testimony is offered in support of the Settlement arrived at by virtually
21 all intervenors in this case, including RUCO. In particular, the focus of my
22 testimony will be on the following areas: public policy, treatment of the
23 PWEC assets and associated competitive issues, energy efficiency and
24 renewable energy. My colleague Marylee Diaz Cortez will offer testimony

1 addressing the revenue requirement, rate design and adjustor mechanism
2 elements in the Settlement.

3

4 Q. Please summarize your testimony.

5 A. The Settlement is a balanced resolution of competing issues and interests.
6 All parties were able to fully audit the APS application; as a consequence,
7 all parties were in a position to negotiate from a standing of relative
8 strength and openness. The process was facilitated well, participants
9 engaged meaningfully, and enough time was permitted to yield an
10 unhurried result. The resulting Settlement has been embraced by the vast
11 majority of participants.

12

13 Q. What are the main provisions of the Settlement?

14 A. From RUCO's perspective, the principal elements include:

- 15 • A total revenue requirement increase of approximately \$75 million for a
16 percentage increase of 4.21%. This increase is composed of a 3.77%
17 base rate increase plus a temporary .44% increase for the Competition
18 Rules Compliance Charge ("CRCC");
- 19 • Incorporation of the PWEC generation assets into the APS rate base at
20 a significant discount to book value;
- 21 • A Power Supply Adjustor ("PSA") mechanism that at once limits annual
22 per kWh price volatility and provides an incentive to the Company to
23 minimize power supply costs;

- 1 • A meaningful commitment to energy efficiency demand-side
2 management programs, designed to total \$48 million in the years
3 2005-07, with provisions for recovery partially through base rates and
4 partially through an adjustor;
- 5 • A commitment to renewable energy via establishment of an adjustment
6 mechanism to fully recover costs incurred as a result of any future
7 order of the Commission to increase the Environmental Portfolio
8 Standard, as well as a commitment by the Company to solicit at least
9 100 MW and 250,000 MWh annually for delivery beginning in 2006;
10 and
- 11 • Competitive procurement of power from wholesale markets, but with
12 an allowance for the Company to self-build generation under certain
13 circumstances.

14

15 **PUBLIC INTEREST**

16 Q. How is the public interest satisfied by this Settlement Agreement?

17 A. At the most fundamental level, the Settlement satisfies the public interest
18 because rate increases have been minimized and will be just and
19 reasonable; the issue of PWEC generation asset treatment has been
20 resolved, providing the Company and other participants with regulatory
21 certainty; the Company is provided an opportunity to earn a sufficient
22 return to satisfy its capital, reliability, service and other needs without

1 being unduly enriched; and the multiple parties representing competing
2 interests have reached consensus on the terms of the Agreement.

3
4 Q. Why is a negotiated settlement process an appropriate way to resolve this
5 matter?

6 A. RUCO believes this case is different from previous APS rate cases,
7 insomuch as this particular case benefited from a full audit by both RUCO
8 and ACC Staff of APS' cost-of-service. More than half a year passed after
9 the filing of the application before intervenors filed their direct testimony,
10 permitting sufficient time for a thorough review of the application.

11 Settlement negotiations began only after all parties had an opportunity to
12 fully review the Company's application and the filed cases of the other
13 intervenors. Further, the binding agreement of the signatories to the
14 Settlement precludes their initiating potentially protracted litigation in the
15 event of an order antithetical to their interests. The Settlement results in
16 clarity and regulatory certainty, without the risk and delays associated with
17 the appeal process. Finally, parties to the Settlement are not asking the
18 Commission to abandon its review and oversight of this case;
19 Commissioners are of course not precluded from questioning the parties
20 to assure themselves that the Settlement is truly balanced and is what it
21 purports to be.

1 **COMPETITIVE ISSUES**

2 Q. Please describe how the PWEC assets were dealt with in the Settlement.

3 A. The disposition of the PWEC assets was resolved in the Settlement. The
4 Company had requested a rate-basing of all Arizona-based PWEC assets
5 at their book value of approximately \$882 million as of June 30, 2004.
6 Many parties objected to the transfer to rate base of the assets for a
7 variety of reasons, including: the perceived lack of an immediate need by
8 the Company for additional generation or power contracts; the desire for
9 greater plant valuation transparency, given that other recent purchases of
10 generation facilities have been at a discount to book value; merchant
11 competitors wanted to assure that rate basing wouldn't permanently
12 extinguish the opportunity for the development of a healthy wholesale
13 market.

14 The timing question was resolved by the Settlement by the agreement to
15 ratebase the PWEC assets all at once. The Settlement addressed the
16 financial concerns of other parties by setting the transfer price at \$700
17 million, a \$182 million discount to the June 30, 2004 book value
18 (\$148 million compared to December 31, 2004 book value). Competitive
19 concerns were in large measure addressed by the development of a fairly
20 large, 1000 MW solicitation that will be open only to non-PWEC, non-APS
21 market participants for delivery in 2007 and beyond.

22

23

24

1 Q. What other competition-related issues were resolved by the Settlement?

2 A. Also of concern to merchant competitors was the Company's continued
3 ability to self-build generation as needed. The Settlement's self-build
4 restriction provides a lengthy window of time for merchants to develop a
5 wholesale electricity market while shielded from competitive pressures
6 that could potentially be brought by the Company building additional
7 generation itself. Importantly, if the wholesale market does not develop as
8 expected, and the Company is able to demonstrate to the Commission
9 that merchant generators cannot cost-effectively meet its needs, the
10 Company could be exempted from this provision.

11
12 **ENERGY EFFICIENCY AND RENEWABLES**

13 Q. Please describe the energy efficiency demand-side management
14 provisions of the Settlement.

15 A. APS agrees to spend \$48 million on energy efficiency programs in the
16 years 2005-07. \$10 million annually will be collected through base rates;
17 the balance will be collected through an adjustor mechanism in the year
18 following actual expenditures. Importantly, a formal collaborative energy
19 efficiency working group with many participants is also established to
20 assist with development and monitoring of energy efficiency programs. All
21 programs recommended by this collaborative working group will require
22 approval by the Commission prior to implementation.

23

1 Q. What benefits does RUCO see in these energy efficiency elements of the
2 Settlement?

3 A. Effective energy efficiency programs can accomplish any and all of the
4 following: customers are made more aware of their ability to control their
5 own energy consumption and therefore, their bills; monies saved on utility
6 bills can be devoted to other productive economic uses; more pervasive
7 use of efficient equipment and appliances reduces the strain and demand
8 on the existing electricity system and reduces the rate at which the future
9 need for generation and accompanying infrastructure increases;
10 environmental benefits to air quality and water quality *and quantity* from
11 reduced consumption of primary fuels to generate electricity.

12
13 Q. Please describe the renewable energy-related provisions of the
14 Settlement.

15 A. The Settlement provides for a mechanism to fully fund an increased EPS,
16 in the event that a finding is made by the Commission in the future that a
17 funding increase is warranted to satisfy the EPS requirements.
18 Additionally, the Company has agreed to issue an RFP in 2005 for not
19 less than 100 MW of renewable energy to be delivered beginning in 2006,
20 with a goal of acquiring not less than ten percent of annual system
21 incremental peak capacity from renewable resources, subject to a cost
22 premium not to exceed 25% over conventional resources. This 100 MW is
23 in addition to any energy and capacity contracts renewable energy

1 providers may win in the 1,000 MW solicitation set aside for competitive
2 supply in an RFP to be let in 2005 for delivery in 2007 and beyond.

3
4 Q. What benefits does RUCO see in these renewable energy elements of the
5 Settlement?

6 A. RUCO agrees with the Commission that increased utilization of
7 indigenous renewable energy resources is beneficial for fuel diversity, risk
8 minimization, sustainable local economic development and for
9 environmental reasons. The Settlement advances responsibly the
10 development of renewables by: establishing a mechanism to sufficiently
11 fund the EPS; reserving a 100 MW capacity opportunity for renewables;
12 establishing a goal of meeting ten percent of future capacity additions from
13 renewables; and providing an opportunity for renewable technologies to
14 compete head-to-head with conventionally-fueled generators in the larger
15 1,000 MW RFP next year. RUCO recognizes that in the case of some
16 renewable technologies, procurement of renewable resources may be at a
17 premium to the market price of conventional technologies. However, for all
18 the reasons cited above, as well as the cost-capping provisions built into
19 the Settlement, RUCO believes the worthy public policy objective of
20 increased use of renewable energy is well served by this Settlement.

21
22 Q. Does this conclude your testimony?

23 A. Yes.