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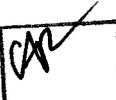


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BEFORE THE ARIZONA CORPORATION COMMISSION

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

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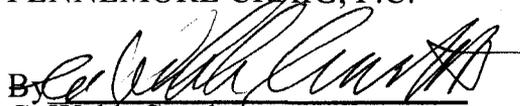
IN THE MATTER OF THE
APPLICATION OF ARIZONA PUBLIC
SERVICE COMPANY FOR A HEARING
TO DETERMINE THE FAIR VALUE OF
THE UTILITY PROPERTY OF THE
COMPANY FOR RATEMAKING
PURPOSES, TO FIX A JUST AND
REASONABLE RATE OF RETURN
THEREON, TO APPROVE RATE
SCHEDULES DESIGNED TO DEVELOP
SUCH RETURN, AND FOR APPROVAL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

DOCKET NO. E-01345A-03-0437

**NOTICE OF FILING THE
SUMMARY OF THE
TESTIMONY OF
KEVIN C. HIGGINS**

Arizonans for Electric Choice & Competition, Phelps Dodge Mining Company,
Federal Executive Agencies, and The Kroger Co. hereby provide notice of filing the
Summary of the Testimony of their witness, Kevin C. Higgins, in the above-captioned
docket in connection with the Proposed Settlement Agreement.

RESPECTFULLY SUBMITTED this 3rd day of November 2004.

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1 The **ORIGINAL** and **13 copies** of
2 the foregoing were filed this 3rd day
of November 2004 with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington
6 Phoenix, Arizona 85007

7 **COPY** of the foregoing **hand-delivered**
8 this 3rd day of November 2004 to:

9 MARC SPITZER, Chairman
10 Arizona Corporation Commission
11 1200 West Washington
12 Phoenix, Arizona 85007

13 WILLIAM A. MUNDELL, Commissioner
14 Arizona Corporation Commission
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16 Phoenix, Arizona 85007

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this 3rd day of November 2004 to:

all parties of record.



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**SUMMARY OF THE TESTIMONY OF
KEVIN C. HIGGINS**

**On Behalf of Arizonans for Electric Choice & Competition,
Phelps Dodge Mining Co., Federal Executive Agencies, and The Kroger Co.**

Docket No. E-01345A-03-0437

November 3, 2004

1 **SUMMARY OF THE DIRECT TESTIMONY OF KEVIN C. HIGGINS**

2

3 With respect to the Settlement Agreement that has been put forward to resolve the
4 issues in this proceeding, I am testifying on behalf of Arizonans for Electric Choice and
5 Competition (“AECC”), Phelps Dodge Mining Company (“Phelps Dodge”), Federal
6 Executive Agencies (“FEA”), and The Kroger Co. (“Kroger”). AECC, Phelps Dodge,
7 FEA, and Kroger represent retail customer interests in the General Service class. AECC,
8 FEA, and Kroger put forward separate cases in the initial phase of this proceeding, but
9 have elected to consolidate their testimony as it pertains to the Settlement Agreement.
10 Each of these parties supports and has signed the Settlement Agreement.

11 I am testifying in support of the Settlement Agreement as proposed by the
12 Stipulating Parties on August 18, 2004.

13 In my opinion, the Settlement Agreement, taken as a whole, produces rates, terms,
14 conditions, and policies that are just and reasonable. Because of the complex tradeoffs
15 among multiple issues and multiple parties, it is essential that the Settlement Agreement
16 be viewed as a total package. The Stipulating Parties have each made concessions in
17 reliance on the advancement of the complete Agreement as negotiated. I strongly
18 recommend adoption of the Settlement Agreement in the form presented by the Parties,
19 as any alterations to the package are highly likely to deprive some Parties of the benefits
20 of their bargains.

21

22 **Revenue requirements**

23 Paragraph 1 of the Settlement Agreement provides that APS will receive a rate
24 increase of \$75.5 million, of which \$67.5 million is in base rates and \$8 million is in the
25 Competition Rules Compliance Charge (“CRCC”). This translates into an average base
26 rate increase of 3.77 percent, plus .44 percent for the CRCC.

27 The Settlement Agreement reduces the initial overall increase requested by APS
28 by approximately 57 percent.

29 In my initial direct testimony, I recommended adjustments that reduced APS’
30 proposed increase of \$175 million by approximately \$150 million. One of these
31 adjustments – denial of the reversal of the \$234 million write-down – is explicitly
32 incorporated into the Settlement results.

33 Another adjustment I had recommended – denial of including certain PWEC
34 assets in APS rate base – was resolved through a compromise that allows these units into
35 rate base, but at a lesser value than was initially sought by APS. The compromise on this
36 issue explains much of the difference in the revenue requirements recommended in my
37 initial testimony and the Settlement result.

38

39 **Rate spread/EPS surcharge rate design**

40 Section XIX of the Settlement Agreement identifies rate increases for the various
41 rate schedules. The Residential class as a whole would see a base rate increase of 3.94
42 percent. Schedules E-32, E-32R, E-34, E-35, E-53, E-54 – which are in the General
43 Service class – and certain contracts would each experience base rate increases of 3.5
44 percent.

1 As AECC, FEA, and Kroger discussed in their initial direct testimony, the APS
2 General Service class is paying rates that subsidize all of the other customer classes. In
3 this situation, it is appropriate for the General Service class to experience a less-than-
4 average increase, and for classes being subsidized to experience a greater-than-average
5 increase. The rate spread in the Settlement Agreement takes a very modest step in the
6 direction of reducing cross-subsidies by moving rates in the direction of cost-of-service.

7 In their respective initial testimonies, AECC, FEA, and Kroger recommended a
8 greater movement toward cost-of-service parity than is provided in the Settlement
9 Agreement. These parties have accepted the Settlement rate spread in light of other
10 considerations in the Settlement Agreement, including, in particular, the Environmental
11 Portfolio Standard (“EPS”) surcharge rate design.

12 Section VIII of the Settlement Agreement addresses the EPS surcharge. Paragraph
13 63 in that section states, in part:

14
15 If the Commission amends the EPS surcharge set forth in Rule 1618 or
16 approves additional EPS funding pursuant to paragraph 64 of this
17 Agreement, *any change in EPS funding requirements resulting from such*
18 *actions shall be collected from APS’ customers in a manner that maintains*
19 *the proportions between customer categories embodied in the current EPS*
20 *surcharge.* [Emphasis added.]
21

22 As laid out in Paragraph 63, the Settlement Agreement establishes rate design
23 parameters for the EPS surcharge. The Settlement Agreement does *not* cap the total
24 funding of the EPS program, nor does it require retention of the current caps if EPS
25 funding is increased from current levels. However, Paragraph 63 does require that
26 changes in EPS funding levels be collected in a manner that maintains the proportions
27 between customer categories embodied in the current EPS surcharge. In other words, if
28 the EPS funding is increased from current levels, the most straightforward means of
29 collecting the increased revenues consistent with the Settlement would be to increase all
30 EPS surcharge rate elements proportionally – the per-kWh charge plus each category of
31 cap.

32 Maintaining the proportionality of the current EPS surcharge among the three
33 categories of customers is a key provision of the Settlement Agreement for AECC,
34 Phelps Dodge, FEA, and Kroger. The presence of this provision in the Agreement,
35 among others, makes it possible for these General Service parties to accept the Settlement
36 Agreement’s rate spread provisions.

37
38 **Rate design (pertaining to base rates)**

39 The Settlement Agreement provides for rates that are differentiated according to
40 the voltage at which each customer takes service. The Settlement Agreement adopts the
41 basic approach proposed by APS in its Application, with some modifications. AECC,
42 FEA, and Kroger each supported APS’ general approach to voltage differentiation (with
43 selected modifications) in previously-filed direct testimony. The Settlement Agreement’s
44 incorporation of this distinction in this proceeding is consistent with the general approach
45 adopted in the vast majority of utility tariffs across the country.

1 The Settlement Agreement modifies APS' initial proposal to recognize two
2 additional facts concerning the costs on the APS system, which were addressed in the
3 initial direct testimonies of AECC, FEA, and Kroger:

4 (1) Paragraph 120 recognizes that military base customers served directly from an
5 APS substation will not be charged for the cost of APS' primary line and
6 secondary distribution investments, and establishes a cost-based voltage discount
7 applicable to military base customers with this service configuration; and

8 (2) The rate design of Schedule E-32 recognizes that customers with demands of
9 100 kW and greater do not utilize APS' secondary feeders. This cost-of-service
10 consideration is recognized in the design of the E-32 demand charge in the
11 Settlement Agreement.

12 The Settlement Agreement also adopts the basic approach to unbundling each
13 schedule's rate components that APS proposed in its Application – an approach that
14 AECC, FEA, and Kroger supported in their initial direct testimonies. Separating
15 individual rate components by function, such as generation, transmission, and
16 distribution, is required by the Electric Competition Rules, and will provide better
17 information to customers. It will make the process of evaluating direct access
18 opportunities more transparent for customers who wish to do so.

19 Specific rates for Schedules E-32, E-34, and E-35 are included in Appendix J of
20 the Settlement Agreement. Whereas the Settlement Agreement summarizes the design
21 objectives negotiated by the parties, it is the negotiated rates themselves, as they appear
22 in Appendix J, that constitute the ultimate basis in reaching agreement for AECC, Phelps
23 Dodge, FEA, and Kroger. Each element of these rate designs was the subject of
24 negotiation over an extended period of time. The relationship between demand and
25 energy charges, the designation of rate blocks, the differentiation of rates by voltage, the
26 demarcation of unbundled components – in short, every component of the General
27 Service rates in Appendix J – is an integral part of the Settlement Agreement and was of
28 material interest in reaching settlement to at least one of the signatory Parties.

29 As Paragraph 121 states, Schedule E-32 was modified in an effort to simplify the
30 design, to make it more cost-based, and to smooth out the rate impact across customers of
31 varying sizes within the rate schedule. The E-32 rate design in the Settlement Agreement
32 is vastly improved relative to the design in the current tariff.

33 In particular, the Settlement Agreement's treatment of Schedule E-32 strikes a
34 proper balance between demand and energy charges. In a system such as APS', in which
35 new distribution infrastructure and new generation resources must be added to meet a
36 growing system peak, it is critical on grounds of both fairness and efficiency to levy a
37 demand charge that sufficiently places cost responsibility on those customers responsible
38 for the costs incurred in meeting the system peak. The demand charge performs this
39 function. Failure to properly weight demand cost responsibility would cause an improper
40 subsidy among the customers within the E-32 rate schedule, which would result in
41 higher-load-factor customers subsidizing the peak-related costs caused by lower-load-
42 factor customers. The Settlement Agreement achieves a proper balancing of costs through
43 the setting of the demand and energy charges.

44 In addition, the Settlement Agreement provides for an optional time-of-use rate
45 that is open to all E-32 customers, increasing the pricing options available to customers

1 on this rate schedule. I offer a clarification regarding some omitted information regarding
2 this rate in my responsive / clarifying testimony.

3 In addition to the general design issues discussed above, Paragraph 118 of the
4 Settlement Agreement retains the existing 11:00 AM to 9:00 PM on-peak time periods in
5 the current tariff. In its initial Application, APS had proposed to modify the definition of
6 this time period, by starting the on-peak period two hours earlier each day. The proposed
7 change would have caused unintended problems for E-35 customers that have adapted
8 their business operations to meet the terms of the existing definitions in the tariff. The
9 Settlement Agreement averts this problem.

10
11 **Demand-Side Management**

12 Paragraph 43 establishes a DSM adjustment mechanism for any approved DSM
13 expenditures in excess of the \$10 million base rate DSM allowance. General Service
14 customers that are demand-billed will pay a per-kW charge instead of a per kWh charge.
15 This allocation *within* the General Service class does not impact the allocation *across*
16 classes, which is performed on a per-kWh basis.

17 Paragraph 55 provides a forum for evaluating the merit of self-direction, which I
18 believe is an important component of any mandatory DSM funding.

19
20 **Direct access service**

21 The Settlement Agreement makes no changes to direct access service. Paragraph
22 82 of the Agreement states that changes to retail access shall be addressed through the
23 Electric Competition Advisory Group or other similar process.

24 APS has agreed to forego any present or future stranded cost claims on the PWEC
25 assets coming into rate base. This provision prevents direct access service from being
26 undercut by a future stranded cost claim resulting from the Settlement Agreement's
27 inclusion of these assets in rate base.

1 **SUMMARY OF THE RESPONSIVE / CLARIFYING TESTIMONY OF**
2 **KEVIN C. HIGGINS**
3

4 My responsive testimony addresses certain arguments in the direct testimony
5 concerning the proposed Settlement Agreement that was pre-filed by Peter F.
6 Chamberlain on behalf of Arizona Cogeneration Association (“AzCA”).

7 A significant portion of Mr. Chamberlain’s testimony is a critique of Rate E-32,
8 and the companion Rate E-32R, which is an *optional* rate for partial requirements service.
9 Mr. Chamberlain’s testimony mischaracterizes the economic basis of Rate E-32, and the
10 related Rates E-32R and E-32-TOU. Notably, Mr. Chamberlain’s testimony contains no
11 substantive discussion of Rate E-52, which is designed exclusively for partial
12 requirements service. In addition, Mr. Chamberlain’s testimony contains serious factual
13 errors, as well as a number of irrelevant comparisons.

14 Among the factual errors in Mr. Chamberlain’s testimony is his claim that rate
15 structures proposed for partial requirements customers produce perverse incentives to
16 increase on peak energy usage and do nothing to encourage (and may, in fact, penalize)
17 load management efforts to shift load to off peak periods. It appears to me that Mr.
18 Chamberlain is simply unaware of the TOU option for E-32R. I demonstrate in my
19 testimony that this statement is simply incorrect.

20 Mr. Chamberlain also claims that it is likely that the tailblock energy rate for Rate
21 E-32 will not recover the actual variable fuel costs of generation. This assertion is also
22 incorrect. The proposed energy tailblock rate for Rate E-32 is \$.03182 per kWh during
23 the winter and \$.04175 during the summer. The base cost of APS fuel and purchased
24 power established in the Settlement Agreement is \$.020743 per kWh. The winter
25 tailblock rate for Rate E-32 is over 50 percent higher than APS’ base energy cost, and the
26 summer tailblock rate is more than double APS’ base energy cost.

27 Mr. Chamberlain also states that Rate E-32 collects transmission costs through a
28 kW charge. This claim is also incorrect. An examination of the unbundled rate for
29 Schedule E-32 shows that under the Settlement Agreement, it is proposed that
30 transmission costs be collected on a per-kWh basis, the opposite of what Mr.
31 Chamberlain contends.

32 The rate components proposed for Rate E-32 are an integral part of the Settlement
33 Agreement. Altering the E-32 rate design as suggested by Mr. Chamberlain would
34 constitute an adverse material change for several parties to the Agreement. Furthermore,
35 as a matter of public policy, it makes no sense to re-design a rate intended for 78,000 *full*
36 requirements customers in an attempt to address special design needs for a relative
37 handful of *partial* requirements customers – when a rate designed specifically for partial
38 requirements service is already available. Mr. Chamberlain’s recommendations to modify
39 Rate E-32 should be rejected in their entirety.

40
41 In my clarifying testimony I point out that there is an omission in the rate table for
42 Rate E-32-TOU, attached to the Settlement Agreement. The table should show a
43 reduction in the delivery-related demand charge after the first 100 kW of load for residual
44 off-peak demand. However, this reduction was inadvertently omitted. Instead of
45 remaining at the initial level of \$7.722 per kW-month (e.g., for secondary), the residual

- 1 off-peak demand charge for delivery should step down exactly as occurs for on-peak
- 2 hours, and for E-32 generally. The initial rate block for residual off-peak delivery will
- 3 only apply to the first 100 kW of *combined* on-peak and residual off-peak load.