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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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Commissioner
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Commissioner

Arizona Corporation Commission
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| IN THE MATTER OF THE APPLICATION OF ARIZONA ELECTRIC POWER COOPERATIVE, INC. FOR A RATE INCREASE | DOCKET NO.E-01773A-04-0528 |
| IN THE MATTER OF THE APPLICATION OF SOUTHWEST TRANSMISSION COOPERATIVE, INC. FOR A RATE INCREASE. | DOCKET NO. E-04100A-04-0527 |

**STAFF'S CLOSING BRIEF**

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## I. INTRODUCTION.

The Utilities Division ("Staff") of the Arizona Corporation Commission submits this Closing Brief in the consolidated rate cases of Arizona Electric Power Cooperative, Inc. ("AEPCO") and Southwest Transmission Cooperative, Inc. ("Southwest") (collectively, the "Applicants"). Happily, Staff and the Applicants were able to resolve most of the issues prior to the hearing. The major remaining dispute concerns Staff's recommended equity goal, even though this is the same goal that the Commission has set for the Applicants in the past. The Applicants also complain about the burden of complying with Staff's recommendation that the Applicants follow the Commission's jurisdictional separation rule, even though a number of much smaller cooperatives manage to follow this rule without a fuss. A final issue concerns a proviso in the AEPCO board resolution concerning step rate increases. In addition, the Administrative Law Judge requested that the parties include in their briefs any undisputed issues which should be addressed in the order.

## II. EQUITY.

### A. AEPCO's and Southwest's equity ratios are dangerously low.

AEPCO and Southwest are imperiled by their dangerously low levels of equity. During the test year, AEPCO's equity was only 4.8% of its capitalization. (Tr. at 133:3-5). Since then, AEPCO's equity position has only worsened, falling to about 3%. (Tr. at 133:15-17). Southwest has not fared any better, as during the test year its equity was 4.7%, and its equity has also fallen to about 3%. (Tr. at 139-40).

There is no question that these equity levels are risky and wholly inappropriate. AEPCO and Southwest's Chief Financial Officer, Dirk Minson, testified that a firm's financial risk increases as its leverage increases. (Tr. at 139:16-18). Staff's equity witness, Alejandro Ramirez, noted that low equity levels cause multiple negative effects, such as: (1) higher debt costs; (2) reduced ability to incur new debt; and (3) upward pressure on rates to meet debt service. (Ex. S-11 at 4:13-18; Ex. S-12 at 4:13-18).

Minson also testified that the cooperatives' equity levels are below the levels of various samples of comparable cooperatives. (Tr. at 134:1-21). For example, Minson referred to a R.W.

Beck study that showed that other generation and transmission cooperatives had a median equity goal of 17.5%. (*Id.*; Ex. AEPCO-2 at 9). Another expert for the Applicants, William Edwards of the National Rural Utilities Cooperative Finance Corporation, testified that the Applicants' equity levels are much lower than his sample group. (Tr. at 55:10-12 and 58:1-3). Edwards admitted that AEPCO and Southwest "would be regarded as speculative and below investment grade" by the market. (Tr. at 57:22-23). Ramirez found an average equity level of 19% for generation and transmission cooperatives rated by Standard and Poor's. (Ex. S-11 at 4 and Schedule AXR-2; Ex. S-12 at 4 and Schedule AXR-2). Moreover, Minson testified that his personal goal for the Applicants' equity ratio was between 15% and 20%. (Tr. at 148:5-13).

Since AEPCO's and Southwest's equity levels are far below that of any of the sample groups, it is no surprise that every witness on this topic agreed that the Applicants' equity levels must be improved. For example, Minson stated the Applicants should "continue to improve its equity position" and that he agrees with the "overall Staff goal of building equity" (Tr. at 96:15-16; 132:22-25; 139-40). Likewise, Edwards testified that "it would be reasonable for AEPCO and Southwest to grow its equity in the future." (Tr. at 58:15-16).

### B. **<u>The Commission should require AEPCO and Southwest to file an equity improvement plan</u>.**

Staff recommends that the Commission order AEPCO and Southwest to file an equity improvement plan. (Ex. S-13 at 8; Ex. S-14 at 6). Minson agreed that the Applicants should file an equity improvement plan. (Tr. at 101). Staff agreed to extend the due date until March 31, 2006. (Tr. at 242:16-23).

### C. **<u>The Commission should set an equity goal of 30%</u>.**

Staff recommends that the Commission set an equity goal for AEPCO and Southwest of 30%. (Ex. S-13 at 5-7; Ex. S-14 at 4-5). This goal is based upon a number of factors, including: (1) the goals set in prior orders concerning AEPCO (Decision No. 64227) and Southwest (Decision No. 64991); (2) the Applicant's need to achieve greater financial flexibility; and (3) an article by Fitch Ratings. (*Id.)* Edwards noted that the Commission has already set 30% as a goal for AEPCO. (Tr. at 75:9-12). The Applicants also admitted in data responses that the

Commission already ordered AEPCO and SWTC to plan to achieve 30% equity by 2015. (Ex. S-23; S-24). Further, the Commission recently approved the same 30% goal for Graham County Utilities, an affiliate of one of the Applicants' members. (Tr. at 135-36; Ex. S-21). Moreover, a 30% goal would be consistent with RUS regulations, which limit patronage refunds (dividends) until 30% is achieved. (Ex. S-23 and S-24, citing 7 C.F.R. § 1717.617).

The Applicants tried to suggest that building equity would result in higher rates. But Ramirez testified that "increasing equity doesn't mean higher rates." (Tr. at 240:3-4). Ramirez explained that firms can build equity by other means, such as decreasing costs or retaining patronage refunds. (Tr. at 254:1-8). Minson also testified that lower levels of debt will reduce interest expense. (Tr. at 139:4-6). Thus, as Ramirez testified, higher equity levels can actually lead to lower rates in the future. (Tr. at 253:11-14).

### D. <u>The Commission should impose additional limits</u>.

Staff also recommends that the Commission limit the Applicants from making patronage refunds. The Applicants should not be permitted to make any patronage refunds while their respective equity levels remain below 20% of their total capitalization. (Tr. at 251-252). If one of the Applicants' equity level is between 20% and 30%, that cooperative's patronage refunds should be limited to 25% of net earnings. (*Id.*). This recommendation parallels the RUS regulation noted above.

In order to ensure that the Applicants make progress in building equity, Staff also recommends that the Applicants be required to file rate cases no later than 3 to 5 years from now. (Tr. at 252). The Applicants do not dispute this recommendation. (Tr. at 147:14-23).

## III. JURISDICTIONAL SEPARATION.

The Commission's rules require that utilities with operations outside Arizona prepare jurisdictionally separated schedules as part of their rate filing. *See* A.A.C. R14-2-103(B) (4). This rule provides, in part:

> Separation of nonjurisdictional properties, revenues and expenses associated with the rendition of utility service not subject to the jurisdiction of the Commission must be identified and properly separated in a recognized manner when appropriate. In addition, all nonutility properties, revenues and expenses shall likewise be segregated.

Unfortunately, the Applicants did not file – and have never filed in any case - jurisdictionally separated information. (Tr. at 185-86). Jurisdictional separation is an important tool that Staff uses to ensure that rates are fair and cost-based. (*Id.*; Ex. S-3 at 9; Ex. S-4 at 6).

Commission regulation of cooperatives serving more than one state is nothing new or unique. Cooperatives such as Duncan, Garkane, and Columbus file jurisdictionally separated information. (Tr. at 185:4-15). They do so even though they are much smaller than AEPCO or Southwest. (Tr. at 186:21-24). This belies the Applicant's complaints that preparing jurisdictional separation studies will be too burdensome or costly. Moreover, once the first study is done, the study is "substantially easier to update" in the future. (Tr. at 201:9-12).

**IV. STEP INCREASES.**

Staff and the Applicants worked together to develop a proposal for "step" rate increases of 1.5% on July 1, 2006 and 1.5% on July 1, 2007. The Applicants stated that this proposal provides for "rate stability and continued rate moderation over the next three years for the Cooperatives, and as importantly, their members." (Tr. at 22:10-12). The step increases are described in Exhibits AEPCO-7 and SWTC-6. Minson testified in support of these step increases. (Tr. at 86-89, 102-104, 144-45). Ramirez also supported the step increases, explaining that they will help the Applicants build equity. (Tr. at 230:9-16). Minson explained that the step increases roughly correspond to increased principal payments the Applicants face over the next few years. (Tr. at 151-53). The step increases allow the Applicants to be "marching in place" rather than losing ground as these new principal payments become due. (Tr. at 153:4). Staff recommends that the revenue requirement be calculated consistent with the step increase proposal. (Tr. at 184-85). Therefore, the revenue requirement should be based upon the final step shown on Exhibits AEPCO-7 and SWTC-6.

The Southwest board approved the step increase proposal shown on Exhibit SWTC-6. [CITE]. At the hearing, Minson noted that the full AEPCO board did not have a chance to approve the step increase proposal shown on Exhibit AEPCO-7. [CITE]. AEPCO submitted a resolution of its board approving the step increase proposal. But this resolution contains a proviso which Staff cannot support. This proviso states:

> However, the AEPCO Board of Directors requests that the effective rate order provide that the 1.5 percent increases will only be enacted after a submittal by AEPCO of relevant financial information to the ACC prior to the scheduled increases, and only if this information demonstrates that the rate increases are necessary to achieve a Debt Service Coverage Ratio of 1.0.... AEPCO staff is instructed to submit all such financial information to the Board for approval prior to its submission to the ACC.

There is no testimony or explanation in support of this proviso. The term "relevant financial information" is undefined. Further, this proviso seems to suggest that further orders of the Commission would be necessary in order to "enact" the step increases. Moreover, the AEPCO board might be able to block any step increases simply by failing to forward the information, since the information must be submitted to the board "prior to its submission to the ACC."

More fundamentally, the proviso appears to be based on the idea that a DSC of 1.0 is reasonable and prudent, and anything in excess is unnecessary. Nothing could be further from the truth. A 1.0 DSC is an absolute rock-bottom minimum level. Ramirez explained: "DSC represents the number of times internally generated cash covers required principal and interest payments on long-term debt." (Ex. S-11 at 6; Ex. S-12 at 6). A DSC of 1.0 thus uses all the available internally generated cash simply to cover required debt payments, with nothing left over and no margin for unexpected events. It doesn't take a financial guru to see that this is not a good idea. One intervenor, Mr. Leonetti, made a similar suggestion for the TIER. AEPCO's own witness, Edwards, strongly rejected Leonetti's shoot-for-the-minimum approach: "if you were to set something at or just marginally above the required -- or, minimum required TIER, that would be a **fairly dangerous** thing to do." (Tr. at 41:2-4)(emphasis added).

In addition, the proviso would make it nearly impossible for AEPCO to build equity. As noted above, AEPCO's equity ratios are dangerously low, and must be improved. Moreover, Southwest's board approved the step increases without the proviso. AEPCO and Southwest are in the same barely-floating boat, and there is no reason to approve the proviso for AEPCO if it is not needed for Southwest. Therefore, Staff recommends that the AEPCO's proviso be rejected and the Commission approve the step increases shown on Exhibits AEPCO-7 and SWTC-6 and order that they take effect without further order of the Commission.

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## V. UNCONTESTED ISSUES.

### A. **DSM adjustor.**

Staff recommends that the Commission approve a Demand Side Management (DSM) adjustor, as described in Ms. Keene's testimony. (Ex. S-7 at 10-12). AEPCO agrees that the DSM adjustor should be approved. (Tr. at 89-90). Although AEPCO agrees with the DSM adjustor, it objects to actually engaging in DSM activities. This is odd, given AEPCO's past history of engaging in DSM activities, and the fact that it performs similar functions relating to the Environmental Portfolio Standard. (Ex. S-25; Ex. S-15 at 30-33; Tr. at 131:12-23). Staff and AEPCO agreed to reserve the issue of what DSM requirements AEPCO should face to the pending DSM rulemaking docket. (Docket No. RE-00000C-05-0230).

### B. **Fuel and purchase power adjustor.**

AEPCO and Staff agree that the Commission should approve a fuel and purchase power cost adjustor ("FPPCA") for AEPCO. The proposed FPPCA is described in Ms. Keene's testimony. (Ex. S-7 at 2-8; Ex. S-8 at 1-3). The FPPCA should include the following six conditions, which are more fully described in Ms. Keene's testimony:

(1) The FPPCA will expire in five years unless extended by the Commission;

(2) The Commission or Staff will have the right to review the prudence of fuel and power purchases at any time.

(3) The Commission or Staff will have the right to review any calculations associated with the FPPCA at any time.

(4) Any costs flowed through the FPPCA are subject to refund if the Commission determines that the costs were imprudent.

(5) AEPCO will file monthly reports with Staff's Compliance Section detailing all calculations relating to the FPPCA and containing the nine minimum requirements specified on page 6 of Ms. Keene's Direct Testimony (Ex. S-7).

(6) AEPCO will file additional monthly reports regarding its generating units, power purchases, and fuel purchases. The report will comply with the minimum requirements specified on pages 7 and 8 of Ms. Keene's Direct Testimony (Ex. S-7).

Staff agrees with AEPCO's suggestion that a separate base cost of power be established for full-requirements and partial-requirements customers. The base cost of power for full-requirements customers should be set at $0.01687 per kilowatt hour. (Ex. S-8 at Appendix 1, page 2). The base cost of power for partial-requirements customers should be set at $0.01603 per kilowatt hour. (Ex. S-8 at Appendix 1, page 1).

**C. Depreciation.**

The Commission should approve the depreciation rates shown on Exhibit DCM-1 of Dirk Minson's Direct Testimony. (Ex. AEPCO-1).

**D. Rate design.**

The Commission should adopt the rates shown on Exhibits AEPCO-7 and SWTC-6, with a few minor revisions, which the Applicants do not dispute. For AEPCO, the phase 1 partial requirements fixed charge should be revised to $790,722 per month. (Tr. at 205:1-8). In phase 3, the partial requirements fixed charge should be $855,113. (Tr. at 205:10-13). For Southwest, Staff's recommended revisions to SWTC-6 are shown on Staff late-filed exhibit EEC-1.

## VI. CONCLUSION.

Staff respectfully requests that its recommendations be adopted for the reasons described above.

RESPECTFULLY SUBMITTED this 9th day of May 2005.

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