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BEFORE THE ARIZONA CORPORATION COMMISSION

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WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

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AZ CORP COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION OF)
NAVOPACHE ELECTRIC COOPERATIVE, INC.)
AN ARIZONA NON-PROFIT CORPORATION)
FOR A FINDING OF FAIR VALUE OF ITS)
PROPERTIES AND A FAIR RETURN)
THEREON, AND FOR APPROVAL OF)
CHANGES TO ITS POLICY MANUAL.)

DOCKET NO. E-01787A-01-0063

STAFF'S NOTICE OF FILING
SURREBUTTAL TESTIMONY

The Utilities Division staff of the Arizona Corporation Commission hereby files the
surrebuttal testimony of Darron Carlson and Asher Emerson in the above-referenced matter.

RESPECTFULLY SUBMITTED this 3rd day of October, 2001.

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Original and ten (10) copies of the foregoing
filed this 3rd day of October, 2001 with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Arizona Corporation Commission
DOCKETED

OCT - 3 2001

Copies of the foregoing were mailed
this 3rd day of October, 2001 to:

Wayne Retzlaff
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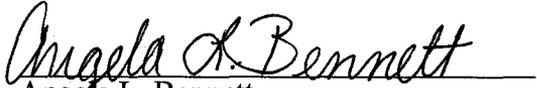
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SURREBUTTAL

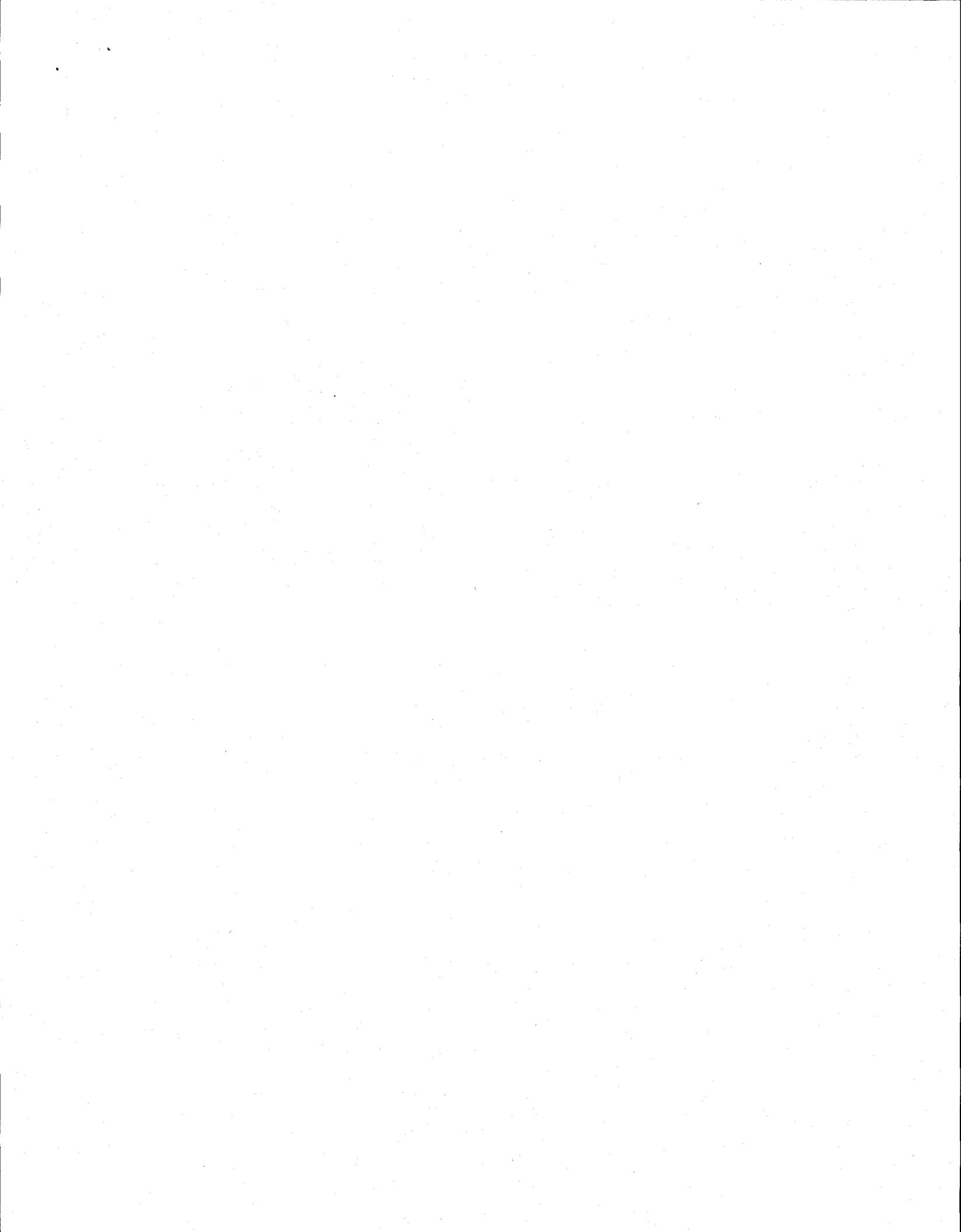
TESTIMONY

OF

**DARRON W. CARLSON
ASHER EMERSON**

DOCKET NO. E-01787A-01-0063

OCTOBER 3, 2001



BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

Commissioner

MARC SPITZER

Commissioner

IN THE MATTER OF THE APPLICATION OF)
NAVOPACHE ELECTRIC COOPERATIVE,)
INC., AN ARIZONA NON-PROFIT)
CORPORATION FOR A FINDING OF FAIR)
VALUE OF ITS PROPERTIES AND A FAIR)
RATE OF RETURN THEREON, AND FOR)
APPROVAL OF RATES AND CHARGES, AND)
FOR APPROVAL OF CHANGES TO ITS)
POLICY MANUAL)
_____)

DOCKET NO. E-01787A-01-0063

SURREBUTTAL

TESTIMONY

OF

DARRON W. CARLSON

SENIOR RATE ANALYST

UTILITIES DIVISION

OCTOBER 3, 2001

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EXECUTIVE SUMMARY
NAVOPACHE ELECTRIC COOPERATIVE, INC.
DOCKET NO. E-01787A-01-0063

The surrebuttal testimony of Staff witness, Darron W. Carlson, addresses the following issues in the rebuttal testimonies of the Company witnesses:

- Operating Times Interest Earned Ratio
- Lobbying Fees
- Treatment of the Gain from the Sale of Plains' Assets
- Standard Offer Tariff Schedule No. 7
- Construction Work in Progress
- Depreciation Expense
- Accumulated Depreciation

Operating Times Interest Earned Ratio ("OTIER") – I recommend reducing Navopache's requested OTIER of 2.00 to an OTIER of 1.50. I believe that the 1.50 OTIER provides Navopache with adequate revenue to fund its operations, contingencies, and its projected debt service.

Lobbying Fees – I recommend removing all lobbying fees from Navopache's requested operating expenses. This is the Commission's normal operating procedure that I believe should include cooperatives along with all other utility entities.

Treatment of the Gain from the Sale of Plains' Assets – I recommend following the Commission's prior order. Navopache wishes to account for the gain in a bookkeeping procedure recommended by the United States Agriculture Department and confirmed by the Company's outside accountants. I believe the prior order requires that the gain should be applied to rates.

Standard Offer Tariff Schedule No. 7 – I recommend a more modest increase than the Company to the rates for cogeneration and small power production facilities. I believe the 400-500 percent increase could cause rate shock and discourage this class of customer.

Construction Work in Progress ("CWIP") – I recommend disallowance of all end of Test Year CWIP, as it is not known and measurable nor used and useful. Navopache attempts to reclassify most of the CWIP to plant in service, not when Staff could verify it, but only in rebuttal testimony – too late for Staff to audit or verify the information.

Depreciation Expense – I recommend the corresponding disallowance of depreciation expense associated with the above mentioned CWIP.

Accumulated Depreciation – Navopache contends that a portion of my pro forma adjustment is incorrect, ignores the larger portion of my adjustment, and then recommends a rebuttal adjustment that almost equals my total adjustment without clarification. Although this does not affect revenue requirement or OTIER, I will pursue clarification.

I continue to recommend my revenue requirement, original cost rate base, and operating income as reflected in Schedules DWC-1, DWC-2, and DWC-9, respectively.

1 **INTRODUCTION**

2 Q. Please state your name and business address.

3 A. My name is Darron W. Carlson. My business address is 1200 West Washington Street,
4 Phoenix, Arizona 85007.

5
6 Q. Are you the same Darron W. Carlson who previously filed direct testimony in this case?

7 A. Yes, I am. I filed my direct testimony on August 15, 2001.

8
9 Q. What is the purpose of your surrebuttal testimony?

10 A. The purpose of my surrebuttal testimony is to provide a portion of Staff's response to the
11 rebuttal testimony filed by Navopache Electric Cooperative, Inc. ("Navopache" or
12 "Company") witnesses, Mr. Wayne A. Retzlaff, Ms. Judy K. Lambert, and Mr. William
13 K. Edwards, on September 12, 2001. The Company's rebuttal testimony is in response to
14 Staff's direct testimony filed on August 15, 2001. I am only addressing the issues that
15 pertain to my direct testimony. Staff witness Mr. Asher Emerson, is addressing rebuttal
16 comments pertaining to issues in his direct testimony.

17
18 Q. How is your surrebuttal testimony organized?

19 A. My surrebuttal testimony follows the same sequence as that of the Company's rebuttal
20 testimony. My surrebuttal testimony begins by addressing the issues raised by Company
21 witness Mr. Wayne A. Retzlaff. These issues include operating times interest earned ratio
22 ("OTIER"), lobbying fees, treatment of the gain from the sale of Plains' assets, and
23 Standard Offer Tariff Schedule No. 7. My surrebuttal testimony then addresses the issues
24 raised by Company witness Ms. Judy K. Lambert. These issues include construction work
25 in progress ("CWIP"), depreciation expense, accumulated depreciation, and OTIER. My
26 surrebuttal testimony ends by addressing Company witness Mr. William K. Edwards'
27 rebuttal comments regarding OTIER.

1 Q. Are you accepting the Company's position on any issues not addressed in surrebuttal
2 testimony?

3 A. No. My lack of response to any issue in this surrebuttal testimony should not be construed
4 as agreement with the Company's rebuttal testimony; rather, where there is no response, I
5 rely on my original direct testimony.
6

7 **COMPANY WITNESS MR. WAYNE A. RETZLAFF**

8 **Operating Times Interest Earned Ratio**

9 Q. After review of the Company's rebuttal testimony, what is your understanding of the
10 Company's position regarding the OTIER?

11 A. The Company's position is that the OTIER of 2.00 that it requests is necessary to
12 adequately fund its operations and construction plan.
13

14 Q. Did the Company offer any outside support for its requested 2.00 OTIER?

15 A. The Company claims that the 2.00 OTIER is very important to its lenders Rural Utilities
16 Service ("RUS") and National Rural Utilities Cooperative Finance Corporation ("CFC").
17

18 Q. Do you agree that the Company needs a 2.00 OTIER?

19 A. No, I do not. While I am confident that a 2.00 OTIER is important to RUS and CFC,
20 neither of these entities has any minimum requirement in any of its loan documents with
21 the Company. The only minimum that I was aware of is the 1.10 OTIER in the RUS
22 codes as already cited in my direct testimony. I am confident that a 2.00 OTIER is not
23 necessary for continued funding of the Company's construction plan and the Company's
24 past history bears this out. I continue to believe that my recommended 1.50 OTIER will
25 provide the Company with all the revenue it needs for operations, contingencies, and
26 servicing its current and projected debt.
27

...

1 Q. Did your analysis include an evaluation of whether Navopache's pending, additional debt
2 that Mr. Retzlaff cites in his rebuttal testimony would have adequate debt service coverage
3 with your recommended revenue?

4 A. Yes, I did analyze Navopache's ability to service the pending \$24,572,000 in new debt.
5 My analysis shows that the Cooperative could service the pending debt with my
6 recommended revenue. As previously stated, I am confident that the 1.50 OTIER
7 produces enough revenue for operations, contingencies, and servicing all of Navopache's
8 current and projected debt.

9

10 **Lobbying Fees**

11 Q. After review of the Company's rebuttal testimony, what is your understanding of the
12 Company's position regarding lobbying fees?

13 A. The Company's position is that lobbying fees should be allowed and recognized as an
14 administrative and general expense within operating expenses because the Company is a
15 cooperative and all of its rate payers are also owners and directly benefit from lobbying
16 activities.

17

18 Q. Did the Company express any other concern regarding your pro forma adjustment to
19 remove lobbying fees?

20 A. Navopache considers my removal of lobbying fees as discriminatory because it has no
21 separate shareholders to subsidize lobbying activities, as do other forms of corporate
22 structure.

23

24 Q. Do you agree that the Company should be able to include lobbying fees in operating
25 expenses?

26 A. No, I do not. The Company has almost 30,000 owner/ratepayers represented by an elected
27 board of directors. The simple ability to elect a board is not an effective control on

1 lobbying activity. Staff believes it is unrealistic to believe that lobbying activities
2 authorized by the board are any more representative of its owner/ratepayers than they
3 would be of ratepayers of a utility with a different corporate structure. Most/all of the
4 Company's owners are owners coincidentally to being ratepayers (one a requirement of
5 the other).

6
7 Further, I believe it would be discriminatory to allow the Company lobbying fees as an
8 operating expense, when this Commission routinely disallows these expenses from other
9 corporate structures. I continue to believe that the proper treatment in this case would be
10 to continue the Commission's normal procedure of disallowing all lobbying expenses.

11
12 **Treatment of the Gain from the Sale of Plains' Assets**

13 Q. After review of the Company's rebuttal testimony, what is your understanding of the
14 Company's position regarding treatment of the gain from the sale of Plains' assets?

15 A. The Company's position is that its proposed accounting treatment of the gain, which is a
16 debit to Cash and a credit to Patronage Capital from Associated Cooperatives, is the
17 proper treatment in this case.

18
19 Q. Did the Company express an opinion on your recommendation for the accounting
20 treatment of this account?

21 A. The Company claims that I "mischaracterize" the context of the Stranded Cost Settlement
22 Agreement ("Settlement Agreement") cited in my direct testimony.

23
24 Q. Do you agree that the Company's proposed accounting treatment is correct?

25 A. No, I do not. I do not have any dispute with the Company in its proposed treatment of the
26 gain, except for the recognition of this Commission's previous order. Contrary to the
27 Company's rebuttal testimony, I believe that the Company is incorrectly interpreting the

1 context of the Stranded Cost Settlement Agreement, (“Settlement Agreement”), as
2 approved previously by this Commission. The Company contends that it was the
3 Commission’s intention to put off disposition of the treatment to the next rate case. This
4 is done routinely. However, in this case, additional wording in the Settlement Agreement
5 guides Staff’s future recommendations. I believe that the specific wording included in the
6 Settlement Agreement requires that Navopache’s share of the gain from Plains’ sale of its
7 transmission and other assets to PNM apply to either Navopache’s distribution rates,
8 generation rates, the CTC, or a combination of these.

9
10 The approved Settlement Agreement does not say that the disposition of the gain shall be
11 determined in the next rate case, but that Navopache shall “address this matter in the next
12 rate case filing.” Article 7.5.3 of the Settlement Agreement adopted in Commission
13 Decision No. 62612, dated June 9, 2000. The Settlement Agreement, in Article 7.5.1, also
14 states, “*At this time, the parties cannot determine whether Navopache’s share of the gain*
15 *from Plains’ sale of its transmission and other assets to PNM should apply to*
16 *Navopache’s distribution rates, generation rates, the CTC, or some combination of*
17 *these.*” Decision No. 62612 at page 5, lines 1-2 provides that “Staff and Navopache
18 agreed that the issue should be considered in Navopache’s next rate case.” It is apparent
19 to me that the Settlement Agreement and the Commission intended that the disposition of
20 the gain be allotted to only one or more of the options listed – not any other disposition. It
21 is my belief that any other disposition would be contrary to a Commission Order.

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1 **Standard Offer Tariff Schedule No. 7**

2 Q. After review of the Company's rebuttal testimony, what is your understanding of the
3 Company's position regarding Standard Offer Tariff Schedule No. 7?

4 A. The Company's position is that its proposed Standard Offer Tariff Schedule No. 7 for
5 sales to cogeneration and small power production facilities is correct and properly reflects
6 the Company's current costs.

7

8 Q. Did the Company express an opinion regarding the size of its proposed increase in these
9 rates?

10 A. The Company claims that the 400 – 500 percent increase in these particular rates will not
11 discourage the small co-generator or small production facility.

12

13 Q. Do you agree that the Company's proposed increase will not discourage the ratepayers in
14 this rate class?

15 A. No, I do not. I do not dispute the Company's cost of service study or that these proposed
16 rates reflect the current costs accordingly. Neither do I dispute any of the other rate
17 changes proposed since they reflected the cost of service. However, cost of service is only
18 one of many rate design considerations. This particular Company proposed increase is so
19 large as to be discouraging, especially to the small co-generator or small production
20 facility. My proposed increases of a more moderate level would alleviate some of the rate
21 shock to this particular rate class and still allow the Company reasonable recovery of its
22 costs.

23 ...

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27 ...

1 **COMPANY WITNESS MS. JUDY K. LAMBERT**

2 **Construction Work in Progress**

3 Q. After review of the Company's rebuttal testimony, what is your understanding of the
4 Company's position regarding CWIP?

5 A. The Company's rebuttal position is that \$3,972,405 of CWIP be reclassified to
6 transmission, distribution plant, and general plant accounts. This is in contrast to the
7 Company's original filing that requested that all of its CWIP, totaling \$4,361,247, be
8 included in total plant in service.

9
10 Q. Does the Company assert that all of its CWIP is used and useful?

11 A. Yes. The Company considers all of its CWIP to be in-service and used and useful.

12
13 Q. Do you agree that all of the Company's CWIP is used and useful?

14 A. No, I do not. Regardless of the Company's treatment of CWIP in its books and records,
15 this Commission routinely disallows CWIP as, by its nature "in progress", not used and
16 useful.

17
18 In an attempt to accommodate the Company, Staff requested a breakdown of post-test year
19 plant additions that might be reflected in the Company's CWIP account that were actually
20 completed projects. This information was not made available to Staff in data request
21 responses or during on-site visits to the Company. Staff was told that the Company was
22 unable to identify which plant accounts and/or portions of job orders were complete. On
23 that basis, Staff was unable to verify that any portion of CWIP was used and useful or
24 even known and measurable.

25
26 The Company presents in its rebuttal testimony a 42-page breakdown of items it wishes to
27 reclassify as plant in service from the CWIP account. Unfortunately, it is much too late in

1 the process for Staff Engineering to verify if and when this particular plant became used
2 and useful. Further, Staff long ago finished its on-site audit review which would have
3 included this particular plant and all its supporting documentation. Staff could not
4 reasonably analyze the effects of potential new revenues and/or reduced expenses that this
5 new unverified plant might create.

6
7 Due to the aforementioned circumstances, I continue to believe that my recommendation
8 to disallow all of the Company's CWIP as the only reasonable determination in this case.

9
10 **Depreciation Expense**

11 Q. After review of the Company's rebuttal testimony, what is your understanding of the
12 Company's position regarding depreciation expense?

13 A. The Company's position is that depreciation expense on its proposed inclusion of CWIP
14 conversions in the amount of \$3,972,405 should also be included in the Company's
15 operating expenses.

16
17 Q. Do you agree that the Company should include this depreciation expense?

18 A. No, I do not. Since I am recommending disallowance of all of the Company's CWIP, I
19 must also recommend disallowance of the associated depreciation expense.

20
21 I continue to recommend my proposed plant and depreciation expense as reflected on
22 Schedules DWC-3 and DWC-9, respectively.

23 ...

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1 **Accumulated Depreciation**

2 Q. After review of the Company's rebuttal testimony, what is your understanding of the
3 Company's position regarding accumulated depreciation?

4 A. The Company's position is that it did not include any depreciation expense on CWIP in its
5 calculation of end-of-Test-Year accumulated depreciation. In my Schedules, I had
6 reduced accumulated depreciation by the amount of depreciation expense booked on the
7 disallowed CWIP.

8

9 Q. Did the Company propose any other adjustment to this account?

10 A. Yes. The Company is now proposing to remove \$337,517 from accumulated depreciation
11 as of the end of the Test Year. This is supposed to represent amortization of plant.

12

13 Q. Do you agree with the Company's position on your pro forma adjustment or the
14 Company's new proposed adjustment?

15 A. No, I do not. As per the Company's Schedule A-10.0, \$4,361,247 of CWIP is included in
16 the Company's end of Test Year Total Utility Plant. This same Schedule reflects
17 depreciation expense of \$141,304 on this CWIP, so I am led to believe that the end of Test
18 Year Accumulated Depreciation would also reflect this booked depreciation expense.
19 There is no indication that CWIP depreciation expense was pro forma and/or not included
20 in accumulated depreciation.

21

22 In addition to the \$141,304 of depreciation expense removed from accumulated
23 depreciation, I also removed \$221,587 of accumulated depreciation associated with
24 unauthorized electric plant acquisition adjustment. The Company does not address this
25 part of my adjustment. These two adjustments totaled \$362,891 in reductions to the
26 accumulated depreciation account that I recommended.

27

1 In reviewing the Company's rebuttal testimony and JKL Rebuttal Schedule 2, it is not
2 clear to me exactly what the Company's proposed rebuttal reduction for amortization of
3 plant to the accumulated depreciation account of \$337,517 actually represents. The
4 Schedule lacks enough detail for analysis.

5
6 Pending clarification from the Company, I continue to recommend my proposed
7 accumulated depreciation reflected on my original Schedule DWC-2.

8
9 **Operating Times Interest Earned Ratio**

10 Q. After review of the Company's rebuttal testimony, what is Ms. Lambert's position
11 regarding OTIER?

12 A. Ms. Lambert supports Company witness Mr. Retzlaff in his position that a 2.00 OTIER is
13 necessary to adequately fund Navopache's operations and construction plan.

14
15 Q. How did the Company support the 2.00 OTIER?

16 A. The Company used a five-year Planning Horizon study to compare the 2.00 and 1.50
17 OTIER projected results.

18
19 Q. Do you agree that the Company needs a 2.00 OTIER?

20 A. No, I do not. The Company testifies that I did not include any analysis of the impact of
21 my proposed 1.50 OTIER on financial and operating ratios. I did review the impact on the
22 ratios, but unlike the Company, did not use five-year projection estimates. The
23 Commission should not base rates on budgetary projections in lieu of standard Test Year
24 procedures. Use of a historical Test Year as adjusted for known and measurable changes
25 is this Commission's standard. The Arizona Administrative Code requires the adherence
26 to Test Year, as adjusted.

27

1 Further, I do not agree that the Company has substantiated the need for a 2.00 OTIER.
2 My calculation of the ratios indicates that a 1.50 OTIER is sufficient to provide the
3 Company enough revenue for operations, contingencies, and its projected debt service.
4 The Company relies on projection estimates to bolster its claim to need a 2.00 OTIER. It
5 is not this Commission's policy to set rates based on estimates. Any changes made to
6 existing rates, must be done utilizing a historical Test Year as its base with only known
7 and measurable adjustments allowed beyond the historical base.

8
9 It remains my opinion that my recommended level of OTIER at 1.50 is sufficient.

10
11 **COMPANY WITNESS MR. WILLIAM K. EDWARDS**

12 **Operating Times Interest Earned Ratio**

13 Q. After review of the Company's rebuttal testimony, what is Mr. Edwards' position
14 regarding OTIER?

15 A. Mr. Edwards testifies that the optimum OTIER should be at least 2.50 though Company
16 witnesses Retzlaff and Lambert testify to an OTIER of 2.00. Mr. Edwards moderates his
17 2.50 OTIER recommendation to 2.00 to limit the magnitude of the resulting rate increase.

18
19 Q. What is the CFC minimum modified debt service coverage ("DSC") ratio for lending
20 purposes?

21 A. Mr. Edwards, an official of CFC, states that, as a minimum, a 1.35 modified DSC ratio is
22 required before the CFC will lend money to a borrower. RUS, as stated earlier in this
23 testimony, has a minimum coverage ratio of 1.10 OTIER.

24
25 Q. What modified DSC ratio results from your recommended revenue?

26 A. My proposed revenue produces a modified DSC ratio of 1.76, a comfortable margin over
27 the CFC's minimum requirement.

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Q. What percentage of Navopache's long-term debt is CFC originated vs. RUS originated?

A. CFC originated debt is 24 percent, with RUS originating the balance of 76 percent.

Q. Do you agree that the Company needs a 2.0 OTIER?

A. No, I do not. Typically RUS funding is more favorable to a utility in that terms and conditions are better/easier than CFC. In many cases, loan packages are sought from both RUS and CFC when the size of the financing package is too large for one lender or other circumstances require more than one lender or use of the higher cost lender.

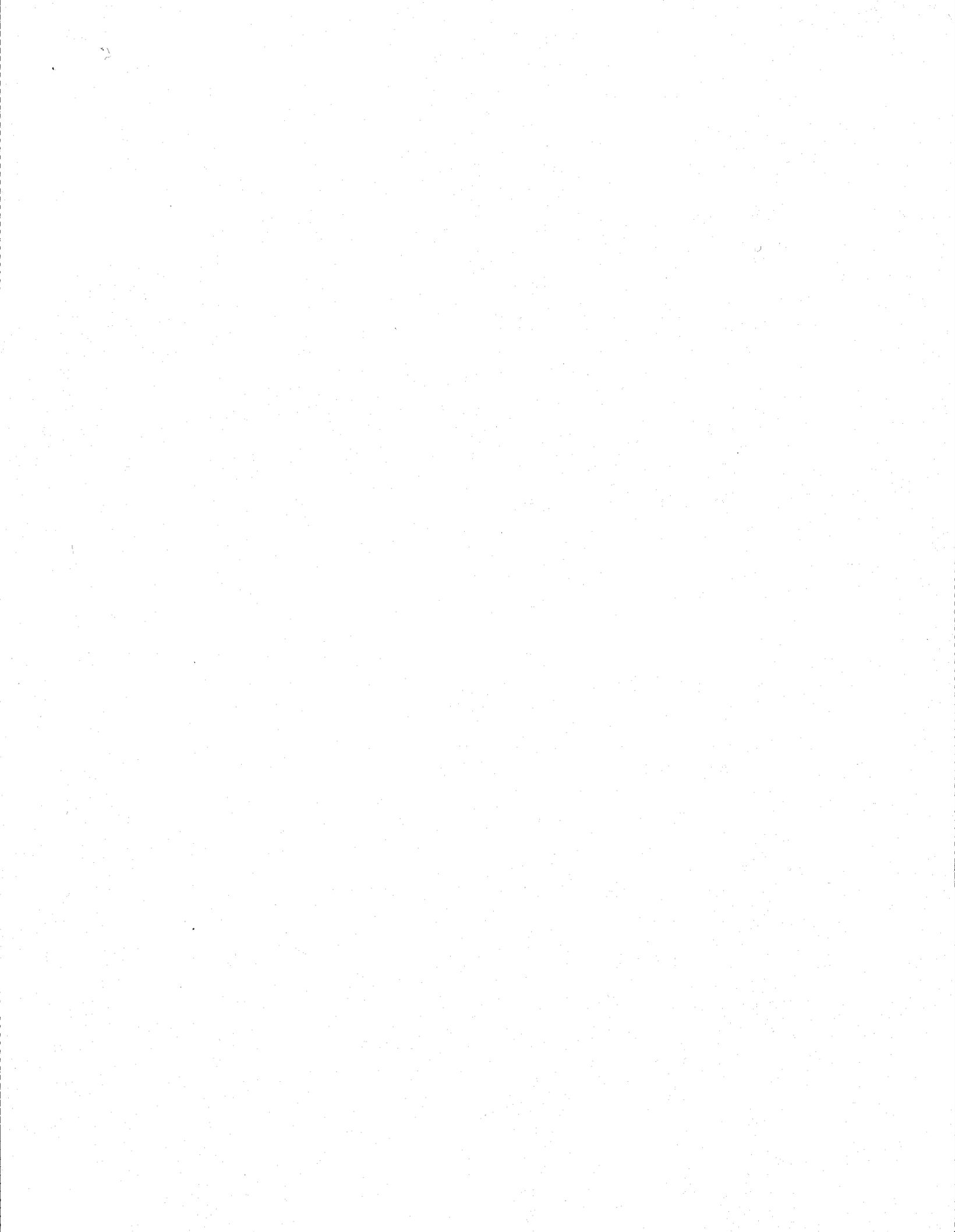
Navopache's entire \$24,572,000 pending finance package is to be funded by RUS with no participation from CFC. My proposed OTIER of 1.50 (using the Company's formulation) actually produces an OTIER of 1.56 according to the RUS formulation, which includes capital credits in the formula. This is 42 percent higher than the minimum requirement and is certainly more than adequate.

As previously discussed, my proposed revenue produces an OTIER of 1.50 and a modified DSC ratio of 1.76. Those ratios exceed the CFC's minimum requirement by a comfortable margin.

I do not believe it is necessary for Navopache's owner/ratepayers to fund a cushion that is not necessary or otherwise required.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.



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SURREBUTAL

TESTIMONY

OF

ASHER D. EMERSON

ELECTRICAL ENGINEER

UTILITIES DIVISION

OCTOBER 3, 2001

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1 **I INTRODUCTION**

2 Q. Please state your name and business address.

3 A. Asher D. Emerson, 1200 West Washington Street, Phoenix, Arizona 85007.

4
5 Q. By whom and in what capacity are you employed?

6 A. I am employed by the Arizona Corporation Commission (“Commission”) as a Utilities
7 Engineer - Electrical in the Utilities Division.

8
9 Q. Are you the same Asher D. Emerson who submitted Direct Testimony in this proceeding?

10 A. Yes, I am.

11
12 **II RESPONSE TO NAVOPACHE'S RECLASSIFICATION OF CWIP**

13 Q. What is the purpose of your surrebuttal testimony?

14 A. The purpose of my surrebuttal testimony is to respond to Navopache's request to move
15 Construction Work in Progress (“CWIP”) to post Test Year plant additions.

16
17 Q. Should the CWIP be reclassified and moved to post Test Year plant?

18 A. No. Staff sent two data requests to Navopache requesting information necessary to
19 determine if the CWIP was placed in service and was used and useful. The first data
20 request was dated May 18, 2001, and the second request was dated July 20, 2001.
21 Navopache's responses to the two data requests were incomplete. Navopache's rebuttal
22 testimony, dated September 12, 2001, provided the additional information. Staff believes
23 that Navopache did not provide the necessary information in a timely manner and there is
24 insufficient time to review the new information for appropriateness and completeness.

25
26 Q. Does this conclude your surrebuttal testimony?

27 A. Yes, it does.

28