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BEFORE THE ARIZONA CORPORATION COMMISSION

In the Matter of the Application of	)	
Arizona Public Service Company for	)	
A Hearing to Determine the Fair Value of the	)	Docket No. E-01345A-05-0816
Utility Property of the Company for Ratemaking	)	E-01345A-05-0826
Purposes, to Fix a Just and Reasonable Rate of Return	)	E-01345A-05-0827
Thereon, To Approve Rate Schedules Designed to	)	
Develop Such Return and to Amend Decision No. 67744	)	

Arizona Corporation Commission  
**DOCKETED**

**INITIAL BRIEF OF THE KROGER CO.**

JAN 23 2007

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**I. INTRODUCTION**

On November 4, 2005, the Arizona Public Service Company (herein referenced as "APS" or "the Company" filed its Application with the Arizona Corporation Commission ("the Commission") in the above captioned matter. APS's Application requests Commission approval of a permanent rate increase of \$405 million or 19.73 percent on average.

The Kroger Co. ("Kroger"), a grocery and consumer goods retailer operating approximately 36 stores in the APS service territory that uses in excess of 100 million kWhs per year was granted intervention and submitted the testimony of expert witness Stephen J. Baron.

Although Kroger is concerned with the overall rate increase requested by the Company, it has focused its efforts on the issues of rate allocation and rate design. Although Kroger supports the APS four coincident peak ("4 CP") cost of service study that it filed in this case, which indicates substantial differences between the rates paid by some customers and the cost to provide service, Kroger believes that the Company's proposed increases to its Residential and General Service rate classes do not provide any

mitigation to this disparity between cost of service and rates. Kroger recommends that the Commission put the Company's cost of service study to use and consider the class cost of service results in its determination of the increases to each rate schedule.

With regard to rate design and in particular the E-32, General Service rate, the Company is essentially proposing a uniform percentage increase to general service customers, despite the fact that the Company's cost of service study shows that rate E-32 customers are paying substantially above cost of service at present rates. On top of this unjustified increase, the Company is proposing to increase higher load factor E-32 customers by even greater percentage amounts than the average retail increase of 21.3%. Kroger recommends that the Commission adopt a rate design that addresses the larger than average subsidy paid by E-32 customers that also does not penalize high-load factor customers who use energy more efficiently and economically than lower load factor customers.

## II. ARGUMENT

### 1. **The Company's Rate Allocation Proposal Ignores The Substantial Interclass Subsidies That Are Shown In Its Own Cost Of Service Study.**

APS submitted a class cost of service study utilizing a 4 CP method. The Company has traditionally used this method because of the pronounced demands on the system during the summer months. The purpose of using this embedded, fully allocated class cost of service study is to assess the reasonableness of a utility's rates, in relation to the underlying cost of providing service to the customers on each rate class. As a matter of policy, it is both efficient and equitable to establish rates on the basis of the cost of service and, to the extent feasible, move rates towards cost of service in a rate case in which a utility is requesting a change in revenues. In other words, a rate case, such as the current APS proceeding, is an opportunity to evaluate the Company's rates and make incremental adjustments so that, over time, each

class will pay rates reflecting cost of service. In so doing, rates paid by each customer will provide efficient “price signals” reflecting the resource cost of meeting customer demands. In addition, cost based rates provide an equitable basis to assign the Company’s overall revenue requirement to customers. When this principle is applied successfully, customers in one rate class do not pay or receive unjustified monetary subsidies from other customers.<sup>1</sup>

Fortunately, the Company’s cost of service study appears to be a reasonable methodology for allocating APS production and transmission related costs. Kroger agrees with APS witness David Rumulo’s explanation of the utility of implementing a 4CP method:

*“Production-related facilities are designed and built to enable APS to meet its system peak load. Therefore, they are allocated on the basis of the average of the system peak demands occurring in the months of June, July, August and September (“4CP”).”<sup>2</sup>*

By tracking the costs of providing service in these four peak, summer months APS’s 4 CP cost of service study provides a reliable model of the relationship between the rates being charged each rate class and the underlying cost of providing service to these customers.

The results of the Company’s cost of service study reveals that certain rate classes are paying substantial subsidies to other rate classes. These inequities are best understood by reviewing the relative class rates of return at present rates. Relative rate of return, which is the ratio of a class’s rate of return relative to the average retail earned rate of return, provides a summary of the rate versus cost relationship, based on the results of the 4 CP cost of service study.

Table 1<sup>3</sup> below summarizes the rates of return and the relative rate of return indices (“ROR Index”) for each of the major rate classes using the results of the Company’s 4 CP study.

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<sup>1</sup> Kroger Exhibit 1; Direct Testimony of Stephen J. Baron p. 10 lines 1-13.

<sup>2</sup> APS Response to Data Request UTI 3-164

<sup>3</sup> Kroger Exhibit 1; Direct Testimony of Stephen J. Baron p. 11 lines 7-17.

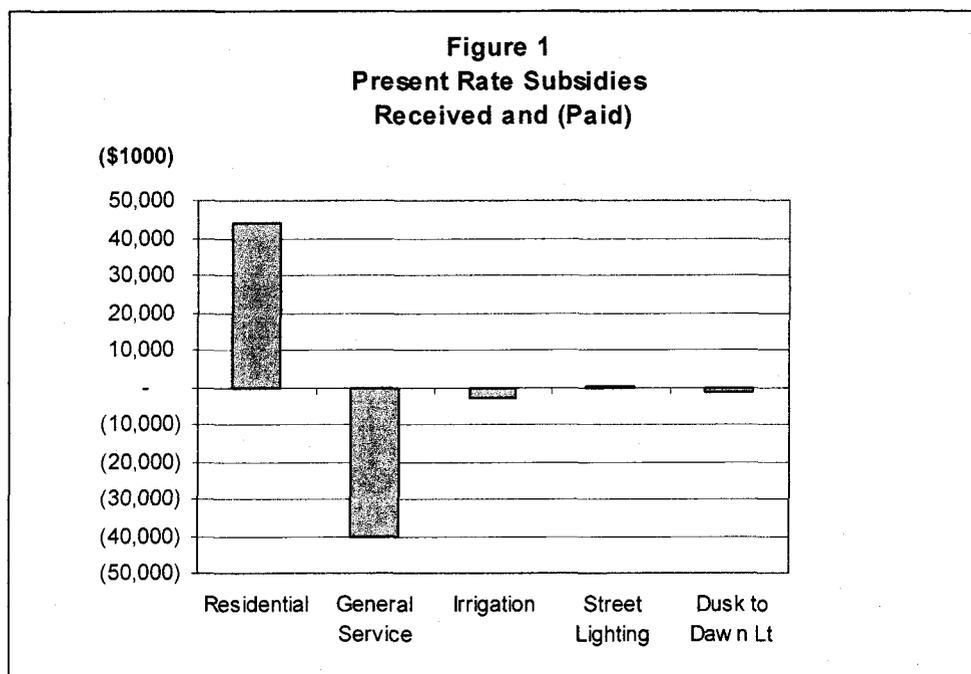
**TABLE 1**  
**Comparison of Relative Rates of Return**  
**4 Coincident Peak Cost of Service Study**

<u>Class</u>	<u>Rate of Return</u>	<u>Rate of Return Index</u>
Residential	1.52%	0.59
General Svc	3.91%	1.51
Irrigation	9.30%	3.59
Street Light	2.05%	0.79
Dusk to Dawn	5.78%	2.23
Total Retail	2.59%	1.00

Based on these results, the residential class is paying less than 60% of its allocated cost of service under present rates, while general service customers are paying a relative rate of return that is approximately 150% of the system average.<sup>4</sup> This is a substantial difference and one that should be addressed in this rate proceeding.

When these subsidies are expressed in real dollars the results are dramatic. Figure 1 below shows the dollar subsidies paid and received at present rates. As can be seen, the Residential class is receiving over \$44 million in subsidies at present rates from other rate classes. At the same time, General Service customers pay annual subsidies of \$40 million.

<sup>4</sup> Although the Company's cost of service study reveals a significant subsidy paid by General Service customers to Residential customers this cost of service study actually understates the subsidy. It is worth noting that the Company has over-allocated OATT transmission expenses to general service rate schedules because of the assumption made that transmission expense allocation should follow the unbundled transmission rate design for transmission and ancillary services in retail tariffs (See APS response to UTI 3-160 d). Irrespective of the transmission cost recovery method using a uniform kWh charge, the Company incurs OATT expenses pursuant to APS OATT Schedule 11, which charges separate, and lower, transmission service rates for general service classes of service, than for residential customers. Therefore, allocating OATT transmission expenses on a uniform kWh basis overstates the allocation of these costs to general service rate classes, including rate E-32. All else being equal, the earned rates of return shown in the Company's class cost of service study are understated for general service rates and the subsidies paid by these rate schedules are even greater than the levels that stated in the Company's cost of service study. (Kroger Exhibit 1; Direct Testimony of Stephen J. Baron p. 12, lines 4-17, p. 13 lines 2-7.)



Despite the results of the Company's cost of service study which shows that large interclass subsidies are being paid from the General Service class to the Residential class, APS does not utilize these results in its rate allocation proposal. APS has not made any attempt to mitigate the cost disparities in this case. Instead, the Company is essentially proposing a uniform percentage increase for the Residential and General Service classes, which comprise about 98% of base revenues.<sup>5</sup> Table 2 shows the proposed percentage rate increases recommended by APS in this proceeding and the resulting rate of return indices. Despite the substantial variation in relative rate of return and the concomitant subsidies being paid by general service customers, APS is recommending an equal across-the-board percentage increase for each rate class.<sup>6</sup> APS's rate allocation proposal is summarized in Table 2 below:

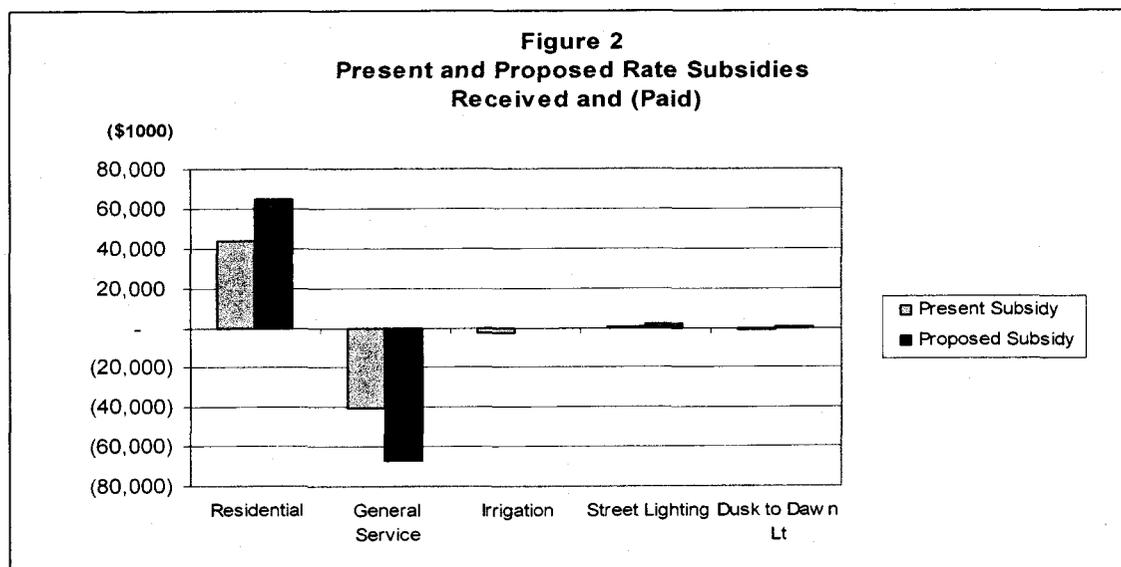
<sup>5</sup> In fact, the Company is proposing a slightly lower percentage increase to residential customers, than general service customers, who are receiving a higher than average increase. (Kroger Exhibit 1; Direct Testimony of Stephen J. Baron p. 14 lines 1-11).

<sup>6</sup> Kroger Exhibit 1; Direct Testimony of Stephen J. Baron p. 14 lines 1-11

**TABLE 2  
APS Proposed Rates**

<u>Class</u>	<u>Proposed % Increase</u>	<u>Proposed Subsidy</u>
Residential	21.14%	64,344,772
General Svc	21.60%	(66,943,047)
Irrigation	0.14%	(269,809)
Street Light	24.11%	2,400,968
Dusk to Dawn	10.50%	467,116
Total Retail	21.14%	0

Figure 2<sup>7</sup> below shows the present and proposed dollar subsidies being recommended by APS in this case. APS is proposing to increase the subsidies received by Residential customers and paid by General Service customers.



<sup>7</sup> Id. p. 15 lines 6-7.

The Company's proposal does nothing to mitigate the inequity of the interclass subsidies contained in current rates and actually worsens the problem by increasing rates on the same percentage basis as current rates. Something must be done in this proceeding to avoid this unfair result.

Although sound ratemaking policy would dictate that rates be set more or less at cost of service, Kroger is not recommending that the Commission eliminate all subsidies by proposing that rates be set at cost. Kroger recognizes that this would not be realistic given the impact on Residential customers. Although cost of service pricing would be ideal and should be recognized as a longer-term goal in future rate proceedings, there is no justification for ignoring the cost of service results and simply increasing rates equally across-the-board as the Company has done. Some mitigation of the subsidies should be made in this case.<sup>8</sup>

If the cost of service study was used directly to allocate the requested \$450 million increase, residential customers would be assigned a \$295 million increase (27%), while general service customers would receive a \$148 million increase (15%). This is the result that would be obtained if 100% of the current subsidies were eliminated in this proceeding. Obviously, it would be unreasonable to increase residential rates by such a substantial amount in a single rate proceeding.<sup>9</sup> However, it is also unreasonable to completely ignore the results of the Company's cost of service study.

A reasonable and balanced approach would be to reduce class subsidies by 25% as an incremental step towards the objective of setting rates based on cost of service. According to Kroger witness Stephen Baron, eliminating 25% of the subsidy would result in an increase to residential customers of \$262.8 million (24%), while producing a \$178.6 million increase (18%) to the general service class.<sup>10</sup> A 25%

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<sup>8</sup> Id. p. 16 lines 4-10.

<sup>9</sup> Id. p. 16 lines 12-17.

<sup>10</sup> Kroger Exhibit 1; Direct Testimony of Stephen J. Baron, Exhibit\_SJB-2

subsidy reduction criterion for allocating the approved revenue requirement increase would still result in proposed rates that contain substantial subsidies, though these subsidies should be reduced going forward.<sup>11</sup>

Table 3<sup>12</sup> below, summarizes Kroger's proposed increases, assuming that the Company received its full rate request. Also shown are the remaining subsidies that will be received and paid, after the 25% reduction at proposed rates.

**TABLE 3**  
**Proposed Rates - 25% Subsidy Reduction**

<u>Class</u>	<u>Proposed % Increase</u>	<u>Proposed Subsidy (\$1000)</u>
Residential	24.1%	33,051
General Svc	18.0%	(30,362)
Irrigation	8.98%	(2,103)
Street Light	31.7%	341
Dusk to Dawn	17.8%	(927)
Total Retail	21.1%	0

Kroger's proposal is also sensitive to the need to mitigate the impact of rate changes to outlying customer classes. The increases recommended in Table 3 reflect a "capping" of the increase to the Street Light class at 1.5 times the system average percentage increase. Absent this adjustment, the increase would have been approximately 1.8 times the system average increase. Also, due to the impact of applying a 25% subsidy reduction to the Dusk to Dawn lighting class, it is appropriate for 100% of the subsidy to this class be removed.<sup>13</sup>

<sup>11</sup> Kroger Exhibit 1; Direct Testimony of Stephen J. Baron p. 17 lines 10-20, p. 18 lines 1-2.

<sup>12</sup> Id. p. 18 lines 4-17.

<sup>13</sup> Id. p. 18 lines 22-23, p. 19 lines 1-4.

Keep in mind that this discussion assumes that the Company's entire revenue increase will be approved. If the Company is authorized a lower increase than requested than Kroger recommends that the dollar increases to each rate class should be reduced on an equal percentage basis.

Finally, as an alternative to its own proposal, Kroger also supports the rate allocation recommendations of Phelps Dodge Mining Company ("Phelps Dodge") and Arizonans for Electric Choice and Competitions' ("AECC") witness Kevin Higgins contained on pages 15 through 18 of Mr. Higgins September 1, 2006, Direct Testimony. Kroger believes that Mr. Higgins recommendations achieve the same goal of moving the respective customer classes a step toward cost of service, without "shocking" the subsidized Residential class with a large and sudden increase.

**2. The Company's Rate Design Proposal Unreasonably Penalizes High-Load Factor E-32 Customers.**

As discussed above, the Company is proposing an overall increase to E-32 (one of the General Service rates) of 21.49%, which is about the average retail increase. Within rate E-32, however, the Company is proposing rate design changes that will result in an increase to some E-32 customers significantly above the 21.49% average increase proposed for the rate. In particular, APS is proposing much larger increases to larger, high-load factor customers taking service on rate E-32, than for lower load factor customers. Table 4<sup>14</sup> below, shows the proposed increases to the delivery service demand charges and the generation energy charges of the rate, for customers taking service at secondary voltage. As can be seen, the proposed percentage increase in the demand charge for demands in excess of 100 kW is 18.1%, while the increase for demands below 100 kW is only 4.9%. This has the obvious effect of increasing the charges to customers above 100 kW by a much larger amount, than for smaller customers.<sup>15</sup>

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<sup>14</sup> *Id.* p. 21 lines 6-7

<sup>15</sup> *Id.* p. 20 lines 5-17.

Similarly, the Company is proposing to increase the generation energy charge for the “first 200 hours use” block by 25.5%, while the increase for all additional kWh is being increased by 50.5%. This creates a very significant impact on rate E-32 customers who have load factors in excess of 27%. Overall, the Company’s E-32 rate design proposal produces a large, disproportionate and adverse impact on high-load factor customers with demands over 100 kW. There is no basis for this unequal treatment of these customers in the Company’s rate design proposal.<sup>16</sup>

**Table 4**  
**Rate E-32 Proposed Increases**

	<u>Present</u>	<u>Proposed</u>	<u>Increase</u>	<u>% Increase</u>
<b>DELIVERY CHARGES</b>				
1st 100 kW	7.722	8.097	0.375	4.9%
All Additional kW	3.497	4.129	0.632	18.1%
All kWh	0.00010	0.00010	-	0.0%
<b>GENERATION CHARGES</b>				
Summer - 1st 200 kWh/kW	0.07239	0.09085	0.01846	25.5%
Summer - All Add'l kWh	0.03476	0.05230	0.01754	50.5%
Winter - 1st 200 kWh/kW	0.06246	0.07555	0.01309	21.0%
Winter - All Add'l kWh	0.02483	0.03700	0.01217	49.0%

E-32 customers are paying millions of dollars in subsidies to the Residential class at both present and proposed rates based on the Company’s proposals in this case. The Company has, in fact, increased the subsidies paid by these customers at proposed rates. This inequitable result is then being further compounded in the Company’s E-32 rate design for larger, high-load factor customers. These customers, who use a greater percentage of the energy use in off-peak periods, are being unreasonably penalized by the APS proposals in this case. APS should encourage the type of efficient energy usage that high-load factor customers practice, not punish customers for using energy efficiently. As Phelps Dodge and AECC witness, Mr. Higgins explains with regard to correct rate design:

<sup>16</sup> Id. p. 20 lines 19-20, p. 21 lines 1-6.

*“Aligning rate design with underlying cost causation improves efficiency because it sends proper price signals. For example, setting a demand charge below the cost of demand understates the economic cost of demand-related assets, which in turn distorts consumption decisions, and calls forth a greater level of investment in fixed assets than is economically desirable.*

*At the same time, aligning rate design with underlying cost causation is important for ensuring equity among customers, because properly aligning with costs minimize cross-subsides among customers. As I stated above, if demand costs are understated in utility rates, the costs are made up elsewhere – typically in energy rates. When this happens, higher-load-factor customers (who use fixed assets relatively efficiently through relatively constant energy usage) are forced to pay the demand-related costs of lower-load-factor customers. This amounts to a cross-subsidy that is fundamentally inequitable.”<sup>17</sup>*

The Company has not, and cannot, provide any cost of service justification for the disparate increases being proposed for high and low-load factor E-32 customers. With regard to the increases to the distribution demand charges, there does not appear to be any explanation. There is no justification for increasing the kW demand charges for demands in excess of 100 kW by more than three times the percentage increase to the “100 kW or below” block.<sup>18</sup>

With regard to the generation energy charges, Mr. Rumolo states on page 26, at lines 4 through 7 of his Direct Testimony that the “*cost emphasis is shifted to high energy use customers*” and that this “*will also encourage energy conservation through an energy-driven price signal.*” No cost of service justification is offered for increasing the second energy block by 50.5 % and the first block by only half this amount.<sup>19</sup>

The Company’s cost of service study does not support the delivery demand charges being proposed by the Company for rate E-32. As shown in the Company’s response to Question 2-2 of the 2<sup>nd</sup> Set of data requests of Distributed Energy Associates of Arizona, the “Index Rate of Return” for E-32 customers at or below 100 kW is lower than the index for E-32 customers in the “101 – 400” kW block and the “401 – 999”

<sup>17</sup> Higgins Testimony p. 21 lines 19-23, p. 22 lines 1-8.

<sup>18</sup> Kroger Exhibit I; Direct Testimony of Stephen J. Baron p. 22 lines 12-15.

<sup>19</sup> Id. p. 22 lines 17-19, p. 23 lines 1-2.

kW block, at both present and proposed rates<sup>20</sup>. Though this is not the case for the “1000+” kW block, these customers only comprise about 12% of E-32 revenue requirements. Based on the cost of service study, there is no basis to increase rates for larger customers by a greater percentage than smaller customers.<sup>21</sup>

Likewise, the Company’s cost of service study does not support the generation charges being proposed by the Company for rate E-32. The unit cost of production energy cost for rate E-32, at the Company’s proposed rate of return (i.e., no subsidies) is about 6.5 cents per kWh.<sup>22</sup> Table 5<sup>23</sup> below shows the unit cost (at an 8.73% rate of return) of production energy for each of the usage blocks of rate E-32.

	Production <u>Energy Rev. Req)</u>	<u>MWh Sales</u>	Unit Cost <u>(cents/kWh)</u>
<20	45,919,976	1,307,541	3.512
20-100	83,566,716	2,511,175	3.328
101-400	108,496,471	3,140,255	3.455
401-999	70,838,916	2,188,928	3.236
1000+	52,655,646	1,626,501	3.237
Total	361,477,725	10,774,400	3.355

As shown back in Table 4, the proposed rate E-32 generation charge for the “all additional kWh” is 5.23 cents per kWh in the summer and 3.7 cents per kWh in the winter. Both of these rates exceed the “all hours” unit cost of production energy of 3.335 cents per kWh.<sup>24</sup>

<sup>20</sup> Id. Baron Exhibit \_ (SJB-3)

<sup>21</sup> Id. p. 23 lines 7-14.

<sup>22</sup> Id. p. 23 lines 19-20

<sup>23</sup> Id. p. 24 lines 2-3.

<sup>24</sup> The “all-hours” rate reflects the weighted average of summer and winter costs. Id. p. 24 lines 5-8.

The Company's proposed percentage increases to the generation energy charges are not reasonable. The Company's argument seems to be that increases in fuel costs justify a more or less uniform "cents per kWh" increase to the generation rates, rather than uniform percentage increases. The problem with this argument is that it presupposes that the existing rates are cost based; which they are not. Therefore, the price-signal benefits cited by Mr. Rumolo require that rates reflect cost, not just that incremental changes reflect cost.

Kroger recommends that the E-32 delivery charges and generation charges be increased by an equal percentage amount, consistent with the dollar increases proposed by the Company for delivery charges and generation charges. However, if the Commission reduces the E-32 revenue requirement to reflect Kroger's recommended allocation of the approved revenue increase and/or the Commission reduces the overall revenue increase, the E-32 rate elements should be reduced proportionately on a percentage basis. Table 6 below shows Kroger's recommended delivery and generation charges (for secondary voltage customers) using a uniform percentage increase to each of the two delivery charges and a uniform percentage increase to each of the two generation rates, consistent with the Company's revenue increases for E-32 delivery and generation charges. Kroger is not recommending changes to the Company's proposed primary and secondary voltage discounts, which should be applied to the rates shown in Table 6<sup>25</sup> to obtain primary and transmission voltage rates. Also, Kroger is not recommending any changes to the Company's proposed E-32 rates for customer charges or for charges associated with service for customers with demands less than 20 kW.<sup>26</sup>

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<sup>25</sup> Id. p. 20 lines 5-13.

<sup>26</sup> Id. p. 25 lines 9-20 p. 26 lines 1-4.

**Table 6**  
**Rate E-32 Proposed Increases - Recommended**

	<u>Present</u>	<u>Proposed</u>	<u>Increase</u>	<u>% Increase</u>
<b>DELIVERY CHARGES</b>				
1st 100 kW	7.722	8.376	0.654	8.5%
All Additional kW	3.497	3.793	0.296	8.5%
All kWh	0.00010	0.00010	-	0.0%
<b>GENERATION CHARGES</b>				
Summer - 1st 200 kWh/kW	0.07239	0.09525	0.02286	31.6%
Summer - All Add'l kWh	0.03476	0.04574	0.01098	31.6%
Winter - 1st 200 kWh/kW	0.06246	0.08218	0.01972	31.6%
Winter - All Add'l kWh	0.02483	0.03266	0.00783	31.5%

Kroger's proposal is also fair and equitable to lower load factor E-32 customers because it merely sets demand and energy charges at cost of service. As Mr. Higgins explained when he addressed this concern from the Company in his Surrebuttal Testimony at p. 12:

*"In the Company's rebuttal testimony, the rate design proposals made by Mr. Baron and myself are characterized as being adverse to low-load-factor customers. A better characterization of our proposal is that they would neutralize the negative impact on higher-load-factor customers in the Company's proposal. Equally weighting demand and energy rate components, as I am recommending, is clearly neutral with respect to load factor."*

Kroger's proposal eliminates a subsidy to lower load factor E-32 customers, it does not carve out a new subsidy for the benefit of high-load factor customers. As a final aside, Kroger's rate design proposal is also completely revenue neutral to the Company and produces identical E-32 revenues for delivery service and generation service, compared to the Company's proposal.<sup>27</sup>

<sup>27</sup> Id. p. 27 lines 1-3.

### III. CONCLUSION

Kroger recommends that the Commission put the Company's cost of service study to use by allowing it to guide the Commission's rate allocate and rate design. Although Kroger does not believe that rates should be set at cost of service because such a policy would result in a sudden and dramatic increase to the highly subsidized Residential Class, the Commission must take some incremental step toward reducing these large subsidies. Kroger recommends that the Commission move each customer class 25% toward cost of service and set E-32 demand and energy rates at cost of service.

Respectfully submitted,



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