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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON - CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

Arizona Corporation Commission

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AZ CORP COMMISSION
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IN THE MATTER OF THE FILING BY TUCSON
ELECTRIC POWER COMPANY TO AMEND
DECISION NO. 62103.

DOCKET NO. E-01933A-05-0650

**TUCSON ELECTRIC POWER
COMPANY'S SUBMISSION OF
PROPOSED RECOMMENDED
OPINION AND ORDER**

Tucson Electric Power Company ("TEP" or the "Company"), through undersigned counsel, hereby respectfully submits its proposed Recommended Opinion and Order ("Proposed Recommended Order"), attached hereto as Exhibit "A".

At the conclusion of the hearing on TEP's Motion to Amend Decision No. 62103, TEP agreed to file its Proposed Recommended Order that would incorporate a framework for providing the Commission Staff and the Intervenors with information to support and better explain market rates and TEP's proposals for modifying the 1999 Settlement Agreement and Decision No. 62103 – the Phase-In Market-Rate Proposal, Cost-of-Service Proposal (with Regulatory Asset and ECAC), and the Hybrid Proposal.

This pleading provides an overview of the provisions included in the Proposed Recommended Order that establish the process and framework for providing information to the parties while at the same time holding current rates and reserving all of the rights of all parties.

EXPLANATION AND COMMENT

I. GENERAL COMMENT – FRAMEWORK FOR CONSIDERATION OF PROPOSALS.

During the course of the proceedings on TEP’s Motion to Amend, various parties expressed the view that, although one or more of TEP’s proposals for a regulatory solution may have merit, it was difficult to fully understand and evaluate the proposals without the information that would typically be provided or obtained through a general rate case. For its part, TEP has analyzed several procedures or frameworks for providing rate case information that would permit full and reasoned consideration of its proposals while at the same time preserving its rights with regard to its basic claim that it is entitled to charge market-based rates established by the Market Generation Credit (“MGC”) under the 1999 Settlement Agreement.

In developing an appropriate procedure and framework, TEP has attempted to resolve several competing interests. For example, those who contend that TEP needs to provide rate case information to allow full analysis of TEP’s compromise proposals also assert that once the rate freeze expires at the end of 2008, TEP’s Standard Offer generation rates must be based on fair value cost-of-service as established through a general rate case. Therefore, in providing rate case information, TEP runs the risk that if a mutually acceptable method for establishing 2009 generation rates is not achieved through this proceeding, it will be faced with the argument that it abandoned or waived its claimed right to charge market based rates by filing a rate case. While TEP has vigorously sought a “regulatory solution” to the current dispute over 2009 generation rates, it has consistently asserted that it has an obligation to preserve its right to pursue its legal remedies under the 1999 Settlement Agreement if an appropriate regulatory solution cannot be achieved.

Another important consideration for TEP is moving the process forward so that new rates are in place as close as possible to the expiration of the Fixed CTC. The 2004 Rate Review confirmed that TEP is under-earning and TEP believes that it will be entitled to a rate increase even if it is returned to some form of cost-of-service generation rates. As a result, the expiration

1 of the Fixed CTC in mid-2008 may result in a temporary reduction of rates only to have rates
2 sharply increase due to implementation of new rates. TEP believes it is in the best interest of all
3 parties to prevent a temporary fluctuation in generation rates resulting from the expiration of the
4 Fixed CTC by having generation rates remain unchanged pending a decision on TEP's motion to
5 amend and a new generation rate structure.

6 In addition to the foregoing issues and concerns, TEP was urged to adopt and implement
7 new Demand Side Management("DSM") and Time of Use ("TOU") programs and to similarly
8 provide a plan for implementing the Commission's newly adopted Renewable Energy Standard
9 and Tariff ("RES") as part of this proceeding. The push for implementation of DSM, TOU and
10 RES programs is complicated by differing views among participants in this proceeding on whether
11 such programs may be implemented outside of a rate case, and TEP's need to be able to recover
12 the considerable cost of these programs through approved tariffs and rates.

13 Through its Proposed Recommended Order, TEP has sought balance the competing
14 interests and concerns of the parties while providing a framework for moving forward with
15 consideration of TEP's proposals for establishing new Standard Offer generation rates. The
16 Proposed Recommended Order establishes a procedure and method for providing the parties with
17 general rate case information while at the same time reserving all the rights of all parties,
18 including TEP, with regard to their conflicting positions concerning the meaning, effect, and status
19 of the 1999 Settlement Agreement. The Proposed Recommended Order also contains a provision
20 that maintains current rates even after the expiration of the Fixed CTC while at the same time
21 providing protection for ratepayers through a credit against future rates if it is later determined that
22 TEP is not entitled to retain these revenues. Finally, the Proposed Recommended Order contains
23 provisions that seek to implement DSM and RES programs through Commission approved tariffs.

24 The specific provisions contained in TEP's Proposed Recommended Order are discussed
25 and set forth below.
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1 **II. PROVISION FOR FILING GENERAL RATE CASE INFORMATION TO**
2 **SUPPORT PROPOSALS.**

3 Although TEP has asserted that it is entitled to charge market-based generation rates under
4 the 1999 Settlement Agreement, TEP made two alternative proposals for amending the 1999
5 Settlement Agreement through the pre-filed testimony of James S. Pignatelli: a Market-Rate
6 Phase-In Proposal and a Cost-of-Service (including Regulatory Asset and ECAC) Proposal. In
7 conjunction with both proposals, TEP has proposed modifications and additions to its existing
8 DSM, TOU and Renewable Energy tariffs.

9 TEP's proposed Market-Rate Phase-In Proposal moderates the rate increase that Standard
10 Offer customers will experience when the Floating CTC expires and rates are determined solely by
11 the MGC. TEP proposes to amend the 1999 Settlement Agreement by imposing a cap on the rate
12 established by the MGC such that no customer class will realize an initial rate increase in excess
13 of 12 percent. The phase-in period would last approximately four years; therefore, it would be
14 mid-2012 before Standard Offer generation rates would be based solely on the MGC, and fully
15 market-based.

16 TEP's proposed Cost-of-Service (including Regulatory Asset and ECAC) Proposal allows
17 a reversion to cost-of-service ratemaking while creating a regulatory asset as a mechanism for
18 addressing the financial impacts to TEP of the 1999 Settlement Agreement. The Cost-of-Service
19 Proposal would implement an ECAC to protect the Company and its customers from market
20 volatility. TEP would immediately file a rate case in 2007 so that the rates would be in effect
21 upon expiration of the Fixed CTC in May 2008. Under this proposal, the exclusivity of TEP's
22 CC&N would be restored.

23 According to Mr. Pignatelli's testimony, the projected rate impact of market-based rates
24 under the MGC using a projected cost of \$7.00 per mmBtu for natural gas, would be a 23 percent
25 increase in 2009. The projected rate impact of the Market Rate Phase-In Proposal would be a 12
26 percent increase in 2009. The projected rate impact of the Cost-of-Service (including Regulatory
27 Asset and ECAC) Proposal would be a 26 percent increase in 2009.

1 During the course of the hearing, Mr. Pignatelli presented a third proposal for amending
2 the 1999 Settlement Agreement which he referred to as the “hybrid proposal.” Under the “hybrid
3 proposal,” TEP’s rates would be established under traditional cost-of-service methodology but at
4 the same time certain generation assets would be re-inserted into TEP’s cost-of-service rate base.
5 In addition, the “hybrid proposal” would include a purchased power and fuel adjustor clause and a
6 greatly reduced regulatory asset, based on TEP’s actual transition costs. The projected rate impact
7 of the “hybrid proposal” would depend on the assets dedicated to the wholesale market.

8 Several Intervenors and members of the Commission have indicated that they cannot fully
9 assess TEP’s proposals for amending the 1999 Settlement Agreement and Decision No. 62103,
10 including future rates without additional information. These parties all expressed that they must
11 have general rate case information on all of TEP’s proposals before they will be in a position to
12 fully understand and evaluate the proposals. Under the Proposed Recommended Order, TEP will
13 file complete rate case information for each of its three generation proposals and provide financial
14 information regarding market generation service rates. The relevant provision in the Proposed
15 Recommended Opinion reads as follows:

16 **A. General Rate Information.**

17 48. In order to advance the settlement negotiations of the parties and provide
18 the Administrative Law Judge and the Commission with additional information
19 necessary to fully assess TEP’s regulatory proposals for amending the 1999
20 Settlement Agreement and Decision No. 62103, TEP will file documentation and
21 information, including Schedules A through H required by A.A.C. R14-2-103, to
22 support TEP’s three proposals for amending the 1999 Settlement Agreement: (i)
23 Market-Rate Phase-In Proposal; (ii) Cost-of-Service (with Regulatory Asset and
24 ECAC); (iii) and Hybrid Proposal. TEP also will present similar information
25 regarding Transmission and Distribution rates alone in the event TEP’s Standard
26 Offer generation service is set by the MGC beginning January 1, 2009
27 (collectively referred to as the “Rate Proposals”). TEP’s Rate Proposals will be

1 based on a test year ending December 31, 2006. The Rate Proposals will be filed
2 in a separate but companion docket ("Rate Proposal Docket") that will be
3 consolidated with this proceeding. TEP will file the Rate Proposals on or before
4 July 2, 2007.

5 **III. PROVISION FOR HOLDING GENERATION RATES AT CURRENT LEVELS TO**
6 **AVOID A TEMPORARY DECREASE AND SHARP INCREASE.**

7 During the hearing, Mr. Pignatelli testified that he was concerned that, even though TEP
8 was under-earning, the Company would be forced to experience a temporary reduction in Standard
9 Offer generation rates upon expiration of the Fixed CTC, only to have rates rise markedly under
10 either market-based or cost-of-service rates. Such an effect could adversely impact both TEP and
11 its customers. TEP believes that it is in the public interest to preserve the status quo and prevent
12 potential significant short-term changes in rates. The Proposed Recommended Order includes a
13 provision directing that TEP's current bundled retail rates remain unchanged until the Rate
14 Proposal Docket is resolved.

15 TEP proposes to keep Standard Offer rates at their current levels by modifying the MGC to
16 adjust for the effect of the termination of the Fixed CTC. The Commission previously approved
17 modifications to the MGC in Decision No. 65751 (March 20, 2003). The Proposed
18 Recommended Order contains a provision that modifies the MGC so that, upon expiration of the
19 Fixed CTC, the MGC shall be increased by an amount equal to the Fixed CTC, which shall have
20 the effect of keeping TEP's current Standard Offer rate unchanged. This modification to the MGC
21 (the "MGC Adjustment") will terminate when the Rate Proposal Docket is resolved. The
22 Proposed Recommended Order also addresses the treatment of the revenues collected as a result of
23 the modification of the MGC and the manner in which these revenue may be credited back to
24 customers. This provision was crafted to address concerns about protecting ratepayers while at
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1 the same time addressing TEP's need to properly recognize and account for the revenue. The
2 relevant provisions in the Proposed Recommended Opinion read as follows:

3 **B. Establishment and Treatment of Rates Pending Decision.**

4 49. TEP notes that the expiration of the Fixed CTC may result in a temporary
5 reduction of rates that TEP believes will sharply increase shortly thereafter due to
6 the resolution of the Rate Proposal Docket. TEP believes that such an effect
7 could adversely impact both TEP and its customers. The Parties to the 1999
8 Settlement Agreement, and Commission Staff, agree that the potential for a
9 temporary reduction of rates followed by a sharp increase of rates shortly
10 thereafter is undesirable and not in the public interest. It is in the public interest
11 to preserve the status quo of TEP's current rate levels and prevent a potential
12 temporary fluctuation of rates. Accordingly, we will direct that TEP's Standard
13 Offer rates remain unchanged and at current levels until the Rate Proposal Docket
14 is resolved.

15 50. TEP proposes to keep Standard Offer rates at their current levels by
16 modifying the MGC to adjust for the effect of the termination of the Fixed CTC.
17 We previously approved modifications to the MGC in Decision No. 65751
18 (March 20, 2003). We are now faced with additional circumstances that justify
19 modifying the MGC as proposed by TEP. Accordingly, we will modify the MGC
20 so that, upon expiration of the Fixed CTC, the MGC shall be increased by an
21 amount equal to the Fixed CTC, which shall have the effect of keeping TEP's
22 current Standard Offer rates unchanged. This modification to the MGC (the
23 "MGC Adjustment") will terminate when the Rate Proposal Docket is resolved.

24 51. The amount of revenue collected as a result of this modification to the
25 MGC will be classified as "True-up Revenue" until a final order is issued in the
26 Rate Proposal Docket or December 31, 2008, whichever occurs first. If the
27 Commission determines that TEP's Standard Offer generation service rates shall

1 be established by the MGC beginning January 1, 2009, then the full amount of
2 True-up Revenue shall be credited to customers over a period of 24 months
3 through a reduction in Standard Offer generation rates. If the Commission
4 determines that TEP's Standard Offer generation service rates shall be established
5 by methods other than the MGC and a retail rate decrease is ordered by the
6 Commission, then the Company shall credit customers for the portion of the True-
7 up Revenue determined to be in excess of the new rates. The portion of such
8 True-up Revenue to be credited to customers shall equal the reduction in TEP's
9 annual revenue requirement, if any, contained in the Commission's final order,
10 multiplied by the ratio of (i) actual retail kWh sales subject to the MGC
11 Adjustment divided by (ii) actual retail kWh sales recorded during the twelve
12 month period ending on the date a final order is issued in the Rate Proposal
13 Docket or December 31, 2008, whichever occurs first. This portion of True-up
14 Revenue shall be credited to customers over a period of 24 months through a
15 reduction in Standard Offer generation rates.

16 **IV. PROVISIONS FOR ADOPTION AND IMPLEMENTATION OF DSM, TOU AND**
17 **RES.**

18 In approving Decision No. 68669, several members of the Commission expressed their
19 desire that DSM, TOU, and RES tariffs be part of the issues addressed and resolved by this
20 proceeding. Accordingly, TEP is committed to move forward with the adoption of DSM, TOU and
21 RES implementation programs despite differing views on whether and how such programs can be
22 adopted outside of rate case. The Proposed Recommended Order contains two provisions
23 adopting and implementing new DSM and RES programs for TEP. The relevant provisions of the
24 Proposed Recommended Order read as follows:
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C. Demand-Side Management Portfolio, Time-Of-Use Rates And Renewable Energy Action Plan.

52. TEP will file a detailed Demand-Side Management (“DSM”) Portfolio, based upon TEP’s existing and proposed DSM programs and a Renewable Energy Action Plan (“REAP”) with the Commission by July 2, 2007. The DSM Portfolio, together with information regarding cost recovery thereof, will be filed in a separate docket for review and approval by Staff and the Commission with the objective that the Commission will ultimately approve the DSM Portfolio, as well as full cost recovery for DSM outside of and separate from whatever decision is reached concerning TEP’s proposals to amend the 1999 Settlement Agreement. Similarly, the REAP and REAP tariff will be filed in the same separate docket for review and approval by Staff and the Commission with the objective that the Commission will ultimately approve the REAP and a REAP tariff that permits full recovery of the costs associated with REAP outside of and separate from whatever decision is reached concerning TEP’s proposals to amend the 1999 Settlement Agreement. In the alternative, DSM and renewable energy issues can be fully addressed and implemented in connection with the adoption of one of TEP’s proposals for amending the 1999 Settlement Agreement in this proceeding. The Time-of-Use rates will be fully addressed and implemented in connection with the adoption of one of TEP’s proposals for amending the 1999 Settlement Agreement in this proceeding.

V. PROVISION FOR PRESERVING RIGHTS OF ALL PARTIES WHILE MOVING FORWARD.

As discussed in the general comments, one of TEP’s principal requirements and conditions for moving forward with a rate case filing is the agreement and understanding of the parties that TEP’s rate filing is made with full preservation of all of its rights and claims arising out of the 1999 Settlement Agreement and Decision No. 62103, including its claimed right to charge market

1 based rates and reservation of its right to enforce its legal rights and remedies for breach of the
2 1999 Settlement Agreement in the event the parties are not able to reach an acceptable regulatory
3 resolution to their dispute. This procedure also requires that all parties are free to consider TEP's
4 proposals in the context of a rate case without concern that they have waived or abandoned any of
5 their legal rights or claims arising out of the 1999 Settlement Agreement. The following
6 provisions seek to protect the rights of all parties in this proceeding while they move forward with
7 consideration of TEP's rate proposals and work to reach a fair and reasonable settlement or other
8 resolution. The relevant provisions in the Proposed Recommended Order read as follows:

9 **D. Full Reservation of Rights.**

10 53. TEP's agreement to file the Rate Proposals in the Rate Proposal Docket is
11 being made for the purpose of providing the Commission, as well as the Parties
12 and Intervenors, information that has been requested to fully evaluate TEP's Rate
13 Proposals. The Rate Proposals are being presented to further settlement
14 discussions between the parties that may result in a mutually acceptable
15 regulatory solution or agreement to modify the 1999 Settlement Agreement and
16 Decision No. 62103. TEP's filing of the Rate Proposals is with full reservation of
17 all its rights and claims, and without waiver of any of its rights or claims, arising
18 out of the 1999 Settlement Agreement and Decision No. 62103.

19 54. Similarly, the participation by Staff and the Intervenors in the Rate
20 Proposal Docket is for the purpose of gaining a better understanding of TEP's
21 proposals for amending the 1999 Settlement Agreement and Decision No. 62103,
22 and to determine whether and to what extent Staff and the Intervenors may
23 support the proposals as a means of establishing new Standard Offer generation
24 rates for TEP. Staff and Intervenors also agree that the Rate Proposals is being
25 presented to further settlement discussions between the parties that may result in a
26 mutually acceptable agreement to modify the 1999 Settlement Agreement and
27 Decision No. 62103. Staff and Intervenors' participation in the Rate Proposal

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1 Docket is with full reservation of their rights and without waiver of any asserted
2 position regarding the proper interpretation of the 1999 Settlement Agreement
3 including Staff's and Intervenors' claims that the 1999 Settlement Agreement is
4 silent as to how rates will be established beginning January 1, 2009 and TEP is
5 not entitled to charge market-based rates based upon the Retail Electric
6 Competition Rules and the impact of the Track A and *Phelps Dodge* decisions.

7 **VI. CONCLUSION.**

8 TEP believes that its Proposed Recommended Order is just, reasonable, fair and in the
9 public interest. The Proposed Recommended Order should be approved and entered by the
10 Administrative Law Judge as the Recommended Opinion and Order to the Commission. TEP
11 similarly urges that the parties support TEP's Proposed Recommended Order before the
12 Commission as a means of moving forward with the important issues and considerations presented
13 in this proceeding. Finally, TEP requests that the Commission adopt TEP's proposed
14 Recommended Opinion and Order as its Order in this Docket.

15 RESPECTFULLY SUBMITTED this 16th day of March 2007.

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17 ROSHKA DEWULF & PATTEN, PLC

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EXHIBIT

"A"

EXHIBIT "A"

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS:

MIKE GLEASON, CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE FILING)
BY TUCSON ELECTRIC POWER)
COMPANY TO AMEND DECISION)
NO. 62103.)
_____)

DOCKET NO. E-01933A-05-0650

DECISION NO. _____

**TUCSON ELECTRIC POWER
COMPANY'S PROPOSED
OPINION AND ORDER**

DATE OF HEARINGS: March 6, 2007 through March 9, 2007

PLACE OF HEARINGS: Tucson, Arizona

ADMINISTRATIVE LAW JUDGE: Jane L. Rodda

IN ATTENDANCE: Mike Gleason, Chairman
William A. Mundell, Commissioner
Jeff Hatch-Miller, Commissioner
Kristin K. Mayes, Commissioner
Gary Pierce, Commissioner

APPEARANCES: Mr. Raymond S. Heyman, Sr. Vice President
and General Counsel, and Michelle
Livengood, Regulatory Counsel, Tucson
Electric Power Company, and Mr. Michael
Patten and Mr. J. Matthew Derstine, Roshka,
DeWulf & Patten PLC, on behalf of Tucson
Electric Power Company;

Mr. C. Webb Crockett, FENNEMORE
CRAIG, PC, on behalf of Arizonans for
Electric Choice & Competition, Phelps Dodge
Mining Company and Asarco;

Mr. Michael M. Grant, Arizona Utility
Investors Association;

Mr. Scott Wakefield, Residential Utility
Consumer Office;

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Mr. Timothy M. Hogan, Arizona Center for Law in the Public Interest; SWEEP and WRA;

Mr. Peter Q. Nyce, Jr., General Attorney, Regulatory Law Office, Office of the Judge Advocate General Department of the Army;

Mr. Christopher Kempley, Chief Counsel, Legal Division, on behalf of the Utilities Division; and

Mr. Christopher Hitchcock, on behalf of Sulfur Springs Valley Electric Cooperative, Inc.

BY THE COMMISSION:

* * * * *

Having considered the entire record herein and being fully advised in the premises, the Arizona Corporation Commission (“Commission”) finds, concludes, and orders that:

FINDINGS OF FACT

Procedural History.

1. In Decision No. 62103 (1999), the Commission modified and then approved a Settlement Agreement entered into by Tucson Electric Power Company (“TEP” or the “Company”), the Residential Utility Consumer Office (“RUCO”), Arizonans for Electric Choice and Competition, Phelps Dodge Mining Company and Asarco, Inc. (collectively “AECC”), and the Arizona Community Action Association and Arizonans for Electric Choice and Competition (the “1999 Settlement Agreement”). The 1999 Settlement Agreement provided for: (a) the commencement of competition in TEP’s service territory; (b) the establishment of unbundled rates, with a rate decrease of one percent in 1999, another rate decrease of one percent in 2000, and a rate freeze thereafter until December 31, 2008; (c) the resolution of stranded cost recovery; and (d) the settlement of TEP’s Electric Competition litigation.

2. On May 4, 2005, TEP filed a Motion for a Declaratory Order and Request for Procedural Conference in the 2004 Rate Review Docket, Docket No. E-01933A-04-0408, and in

1 the generic Retail Electric Competition Rules (“Rules”) restructuring dockets, Docket Nos. E-
2 00000A-02-0051, E-00000A-01-0630, E-01345A-01-0822 and E-01933A-02-0069. The Motion
3 sought clarification of whether TEP would be entitled to charge market-based Standard Offer
4 generation rates beginning January 1, 2009. After Staff and others filed oppositions to the Motion
5 for Declaratory Order, the Administrative Law Judge issued a procedural order suggesting TEP
6 consider reopening certain dockets pursuant to A.R.S. §40-252, given that the Motion for
7 Declaratory Order appeared to be a request to clarify Decision No. 62103 which approved the
8 1999 Settlement Agreement.

9 3. On September 12, 2005, the Company filed a Motion to Amend Decision No. 62103
10 pursuant to A.R.S. §40-252 (“Motion to Amend”). The Motion to Amend sought resolution of the
11 dispute over whether TEP is entitled to charge market-based rates for generation service under
12 Decision No. 62103 and the 1999 Settlement Agreement. At the same time, TEP filed the Direct
13 Testimony of James S. Pignatelli.

14 4. In its Motion to Amend, TEP proposed to amend Decision No. 62103 to provide for:
15 (a) the extension beyond December 31, 2008, of the existing TEP rate freeze at TEP’s base rate;
16 (b) the retention of the current competition transition charge (“CTC”) amortization schedule; (c)
17 the agreement of TEP not to seek rate treatment for certain generation assets; and (d) the
18 implementation of a mechanism to protect TEP and its customers from energy market volatility to
19 be effective after December 31, 2008. According to TEP, this proposal was a short-term, interim
20 solution in order to give the parties more time to agree upon how TEP’s generation rates would be
21 determined in 2009.

22 5. Intervention was granted to the Department of Defense (“DOD”); AECC;
23 International Brotherhood of Electrical Workers AFL-CIO Local Union 1116 (“IBEW Local
24 1116”); the Arizona Utility Investors Association, Inc. (“AUIA”); and RUCO.

25 6. On September 22, 2005, AECC filed a Motion to Suspend Proceedings.

26 7. On September 30, 2005, TEP filed a Response to AECC’s Motion to Suspend.

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1 8. On October 12, 2005, AECC, RUCO, and Commission Utilities Division Staff
2 (“Staff”) filed Responses to TEP’s Motion to Amend.

3 9. On October 21, 2005, TEP filed a Reply in Support of its Motion to Amend.

4 10. On October 24, 2005, a procedural conference on oral argument on TEP’s Motion to
5 Amend was held at the Commission’s offices in Phoenix, Arizona.

6 11. On January 30, 2006, the Administrative Law Judge issued a Recommended Opinion
7 and Order.

8 12. On February 8, 2006, TEP filed Exceptions to the Recommended Opinion and Order.
9 TEP argued that Decision No. 62103 and the 1999 Settlement Agreement give it the right to
10 charge market-based rates for generation service calculated by the market generation credit
11 (“MGC”) after 2008. TEP argued that it and its customers deserve certainty and suggested that the
12 Commission conduct a hearing pursuant to A.R.S. §40-252 to consider the Motion to Amend.

13 13. On April 2, 2006, the matter was considered at an Open Meeting of the Commission.

14 14. On April 20, 2006, the Commission issued Decision No. 68669, in which it ordered
15 that a hearing should be held under A.R.S. §40-252 to consider amending Decision No. 62103 and
16 the 1999 Settlement Agreement. It found that the hearing, at a minimum, should address the
17 following issues: (a) the viability of the 1999 Settlement Agreement in light of Decision No.
18 65154 (the “Track A Order”), Decision No. 65753 (the “Track B Order”), and *Phelps Dodge Corp*
19 *v. Arizona Elec. Power Co-op, Inc.*, 207 Ariz. 95, 83 P.3d 573 (Ct. App. 2004) (“*Phelps Dodge*”)
20 (including a discussion and presentation of evidence regarding the individual parties’ opinions of
21 whether TEP will be able to charge market-based rates or cost-of-service rates after 2008); (b) the
22 proposals outlined in TEP’s original application; and (c) Demand-Side Management (“DSM”),
23 Renewable Energy Standards (“RES”), and Time-of-Use (“TOU”) tariffs. Accordingly, the
24 Commission directed the Hearing Division to schedule a hearing to consider amending Decision
25 No. 62103 and establish a procedural schedule in this matter. The schedule was to allow for an
26 expeditious but complete review of these matters. The Commission also held that it could discern
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1 no reason why the current CTC amortization schedule required modification at the time. Thus,
2 until further order of the Commission, the current CTC amortization schedule as set forth in
3 Decision No. 62103 was to remain in effect.

4 15. On June 1, 2006, the Administrative Law Judge issued a Procedural Order setting a
5 schedule for the hearing directed by Decision No. 68669 and granting Mesquite Power, LLC,
6 Southwestern Power Group II, LLC, Bowie Power Station, LLC ("Mesquite/SWPG/Bowie") and
7 Sempra Energy Solutions' ("SES") Application to Intervene and setting a procedural schedule.

8 16. On June 21, 2006, the Administrative Law Judge granted the intervention of the
9 Arizona Competitive Power Alliance ("Alliance").

10 17. On August 18, 2006, TEP filed the Direct Testimony of James S. Pignatelli. As part
11 of the testimony, TEP presented two proposals for generation rates beginning in 2009: (i) a market
12 phase-in proposal that would move TEP to market-based generation in two steps and (ii) a
13 traditional cost-of-service proposal that included an \$850 million regulatory asset and an adjutor
14 ("ECAC").

15 18. On August 25, 2006, the Administrative Law Judge granted the interventions of APS,
16 Southwest Energy Efficiency Project ("SWEEP") and Western Resource Advocates ("WRA").

17 19. On August 29, 2006, the Administrative Law Judge issued a Procedural Order stating
18 that the proposals found in Mr. Pignatelli's Direct Testimony appeared to deviate from TEP's
19 initial proposal as described in its Motion to Amend. The Administrative Law Judge found that
20 the testimony "raises the question whether the timeline and scope of the proceeding as described in
21 the June 1, 2006 Procedural Order remain realistic," and inquired whether or not the public notice
22 was adequate in light of the new testimony. Comments and recommendations were requested by
23 September 11, 2006.

24 20. On September 15, 2006, the Administrative Law Judge scheduled a procedural
25 conference for September 21, 2006. On October 10, 2006, a modified procedural schedule was
26 issued that directed TEP to publish a revised notice which extended the date for intervention.

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1 21. On October 20, 2006, Staff filed a request for an extension of time pointing to the
2 involvement of senior Staff members in the APS rate case proceedings.

3 22. On October 30, 2006, TEP filed a response urging that the current proceeding not be
4 unduly delayed and requesting that case move forward under the procedural schedule established
5 in the October 10, 2006 Procedural Order.

6 23. On November 3, 2006, the Administrative Law Judge issued a modified procedural
7 schedule which allowed Staff and Intervenors additional time to file direct testimony.

8 24. On December 6, 2006, the Administrative Law Judge granted Sulphur Springs Valley
9 Electric Cooperative, Inc.'s ("SSVEC") Application for Leave to Intervene.

10 25. On January 8, 2007, Staff, RUCO, SWEEP, IBEW Local 1116, DOD, and AECC
11 filed Direct Testimony and Exhibits.

12 26. On January 29, 2007, TEP filed the Rebuttal Testimony of James S. Pignatelli and
13 James R. Pyers.

14 27. On February 6, 2007, TEP and Commission Staff filed a letter requesting a
15 continuance to allow parties to participate in settlement discussions.

16 28. On February 8, 2007, the Administrative Law Judge issued a procedural order
17 requesting objections and comments to the request for a continuance by February 12, 2007.

18 29. On February 8, 2007, the Surrebuttal Testimony of Dr. Michael Ileo and Ms. Barbara
19 Keene on behalf of Commission Staff, Mr. Kevin Higgins on behalf of AECC, Ms. Marylee Diaz
20 Cortez on behalf of RUCO, and Mr. Jeff Schlegel on behalf of SWEEP was filed.

21 30. On February 15, 2007, TEP filed the rejoinder testimony of Mr. James Pignatelli.

22 31. On February 15, 2007, a procedural conference was held to consider the joint request
23 of TEP and Staff to continue the scheduled start of the hearings on TEP's Motion to allow the
24 parties to participate in settlement discussions. On February 16, 2007, the Administrative Law
25 Judge issued a procedural order that, among other things, ordered the hearing to convene on
26 February 20, 2006 for the purpose of taking Public Comment only, and following the Public
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1 Comment, the hearing would be recessed until March 6, 2007. The procedural order also directed
2 that the parties will meet during the period February 20-23, 2007 for the purpose of discussing
3 settlement.

4 32. On February 26, 2007, the parties appeared for a procedural conference and advised
5 that no settlement had been reached.

6 33. On March 6, 2007, the hearing was reconvened. At that time, the Administrative
7 Law Judge took administrative notice in this Docket of the 1999 TEP Settlement Agreement
8 Docket (Docket No. E-01933A-98-0471 et al.) and the 2004 TEP Rate Review Docket (Docket
9 No. E-01933A-04-0408).

10 34. The hearing continued over four days. Testimony was presented by James S.
11 Pignatelli and James R. Pyers on behalf of TEP; Kevin Higgins on behalf of AECC; Dan L.
12 Neidlinger on behalf of DOD; MaryLee Diaz-Cortez on behalf of RUCO; Jeff Schlegel on behalf
13 of SWEEP; and Michael J. Ileo and Barbara Keene on behalf of Commission Staff.

14 35. During the course of testimony by Mr. Pignatelli, TEP indicated that it had
15 formulated an additional proposal for amending the 1999 Settlement Agreement and Decision No.
16 62103 that was a "hybrid proposal" under which TEP's rates would be established by cost-of-
17 service methodology but that certain generation assets would be removed from TEP's cost-of-
18 service rate base and that these assets would be dedicated to wholesale market transactions. In
19 addition, the "hybrid proposal" would include a purchased power and fuel adjustor clause and a
20 greatly reduced regulatory asset.

21 36. In connection with its "hybrid proposal," TEP advised that it would present a
22 procedural framework that would (i) address the concerns expressed by Staff, AECC, RUCO, and
23 DOD that the parties could not properly evaluate TEP's new "hybrid" or other alternative
24 proposals for amending the 1999 Settlement Agreement and Decision No. 62103 without the
25 information that would be provided in a general rate case filing, and (ii) reserve all parties' rights
26 if a mutually acceptable amendment to the 1999 Settlement Agreement was not achieved through
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1 the process of analyzing TEP's various proposals through an informational rate case filing.

2 37. In addition, TEP advised that a key consideration in agreeing to provide full general
3 rate case information on its various proposals and going through the cost and expense of a
4 companion rate case proceeding, would be holding its Standard Offer generation rates at current
5 levels pending the outcome of the rate case proceeding rather than having its Standard Offer
6 generation rates reduced when the Fixed CTC expires in or about May 2008. According to TEP, it
7 would make no sense to have customers experience a rate reduction resulting from the expiration
8 of the Fixed CTC only to have rates immediately rebound to higher levels.

9 38. TEP characterized its proposal to provide full rate case information and initiate a
10 companion rate case that will be used to evaluate its proposals for amending that 1999 Settlement
11 Agreement and Decision No. 62103 as a means for furthering settlement discussions and
12 negotiations between the parties to the 1999 Settlement Agreement while at the same time placing
13 the Administrative Law Judge and ultimately the Commission in a better position to render a
14 decision in this proceeding on TEP's Motion to Amend.

15 39. In response, the ALJ, those Commissioners present, Commission Staff, AECC,
16 RUCO, and DOD expressed their willingness to consider TEP's proposal to file a companion rate
17 case that would be used to evaluate TEP's various proposals for amending the 1999 Settlement
18 Agreement and Decision No. 62103. The parties further expressed their willingness to consider
19 having TEP's Standard Offer generation rates held at current rates pending a final determination
20 on TEP's rate proposals and a decision on new rates if ratepayers were protected. For its part,
21 SWEEP indicated its support for the proposal to move forward with a companion rate case if TEP
22 immediately presented and implemented a new interim DSM program that would not await the
23 outcome of TEP's rate case filing and a final decision on the new rates and issues raised in this
24 proceeding.

25 40. At the conclusion of the hearing, it was agreed by TEP and the other parties to the
26 proceeding that TEP would present the details of its proposal for providing the parties with full
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1 general rate case information on all of its proposals for amending the 1999 Settlement Agreement
2 and Decision No. 62103, through a proposed recommended opinion and order. Other parties
3 would then have an opportunity to consider and comment on TEP's proposed recommended
4 opinion and order. The Administrative Law Judge would then issue a recommended opinion and
5 order that would take the positions of the various parties into account.

6 41. At the conclusion of the hearing, the Administrative Law Judge issued a procedural
7 order confirming the foregoing agreement of the parties and establishing timeframes for moving
8 forward with consideration of TEP's proposed recommended opinion and order.

9 **TEP's Proposals for Establishing Standard Offer Generation Rates.**

10 42. While TEP asserts that it is entitled to charge market-based generation rates under the
11 1999 Settlement Agreement, TEP made two alternative proposals for amending the 1999
12 Settlement Agreement through the prehearing testimony of James S. Pignatelli: a Market-Rate
13 Phase-In Proposal and a Cost-of-Service (including Regulatory Asset and ECAC) Proposal. Under
14 both proposals, TEP has proposed modifications and additions to its existing DSM, TOU and
15 Renewable Energy tariffs.

16 43. TEP's proposed Market-Rate Phase-In Proposal moderates the rate increase that
17 Standard Offer customers will experience when the Floating CTC expires and rates are determined
18 solely by the MGC. TEP proposes to amend the 1999 Settlement Agreement by imposing a cap on
19 the rate established by the MGC such that no customer class will realize an initial rate increase in
20 excess of 12 percent. The phase-in period would last approximately four years; therefore, it would
21 be mid-2012 before Standard Offer generation rates would be based solely on the MGC, and fully
22 market-based.

23 44. TEP's proposed Cost-of-Service (including Regulatory Asset and ECAC) Proposal
24 allows a reversion to cost-of-service ratemaking while creating a regulatory asset as a mechanism
25 for addressing the financial impacts to TEP of the 1999 Settlement Agreement. The Cost-of-
26 Service Proposal would implement an ECAC to protect the Company and its customers from
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1 market volatility. TEP would immediately file a rate case in 2007 so that the rates would be in
2 effect upon expiration of the Fixed CTC in May 2008. Under this proposal, the exclusivity of
3 TEP's CC&N would be restored.

4 45. According to Mr. Pignatelli's testimony, the projected rate impact of market rates,
5 using a projected cost of \$7.00 per mmBtu for natural gas, would be An approximately 23 percent
6 increase in 2009. The projected rate impact of the Market Rate Phase-In Proposal would be a 12
7 percent increase in 2009. The projected rate impact of the Cost-of-Service (including Regulatory
8 Asset and ECAC) Proposal would be an approximately 26 percent increase in 2009.

9 46. As set forth above, during the course of the hearing, Mr. Pignatelli presented a
10 "hybrid" proposal for amending the 1999 Settlement Agreement. Under the "hybrid proposal,"
11 TEP's rates would be established under traditional cost-of-service methodology but at the same
12 time certain generation assets would be removed from TEP's cost-of-service rate base and these
13 assets would be dedicated to wholesale market transactions. In addition, the "hybrid proposal"
14 would also include a purchased power and fuel adjustor clause and a greatly reduced regulatory
15 asset, based on TEP's actual transition costs. The projected rate impact of the "hybrid proposal"
16 would depend on the assets dedicated to the wholesale market.

17 47. The parties other than TEP and members of the Commission have indicated that they
18 prefer to have general rate case information on all of TEP's proposals before they can be in a
19 position to fully understand and evaluate the proposals.

20 **Process for Considering TEP's Proposals.**

21 **A. General Rate Information.**

22 48. In order to advance the settlement negotiations of the parties and provide the
23 Administrative Law Judge and the Commission with additional information necessary to fully
24 assess TEP's regulatory proposals for amending the 1999 Settlement Agreement and Decision No.
25 62103, TEP will file documentation and information, including Schedules A through H required
26 by A.A.C. R14-2-103, to support TEP's three proposals for amending the 1999 Settlement
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1 Agreement: (i) Market-Rate Phase-In Proposal; (ii) Cost-of-Service (with Regulatory Asset and
2 ECAC); (iii) and Hybrid Proposal. TEP also will present similar information regarding
3 Transmission and Distribution rates alone in the event TEP's Standard Offer generation service is
4 set by the MGC beginning January 1, 2009 (collectively referred to as the "Rate Proposals").
5 TEP's Rate Proposals will be based on a test year ending December 31, 2006. The Rate Proposals
6 will be filed in a separate but companion docket ("Rate Proposal Docket") that will be
7 consolidated with this proceeding. TEP will file the Rate Proposals on or before July 2, 2007.

8 **B. Treatment of Existing Rates Pending Decision.**

9 49. TEP notes that the expiration of the Fixed CTC may result in a temporary reduction
10 of rates that TEP believes will sharply increase shortly thereafter due to the resolution of the Rate
11 Proposal Docket. TEP believes that such an effect could adversely impact both TEP and its
12 customers. The Parties to the 1999 Settlement Agreement, and Commission Staff, agree that the
13 potential for a temporary reduction of rates followed by a sharp increase of rates shortly thereafter
14 is undesirable and not in the public interest. It is in the public interest to preserve the status quo
15 of TEP's current rate levels and prevent a potential temporary fluctuation of rates. Accordingly,
16 we will direct that TEP's Standard Offer rates remain unchanged and at current levels until the
17 Rate Proposal Docket is resolved.

18 50. TEP proposes to keep Standard Offer rates at their current levels by modifying the
19 MGC to adjust for the effect of the termination of the Fixed CTC. We previously approved
20 modifications to the MGC in Decision No. 65751 (March 20, 2003). We are now faced with
21 additional circumstances that justify modifying the MGC as proposed by TEP. Accordingly, we
22 will modify the MGC so that, upon expiration of the Fixed CTC, the MGC shall be increased by
23 an amount equal to the Fixed CTC, which shall have the effect of keeping TEP's current Standard
24 Offer rates unchanged. This modification to the MGC (the "MGC Adjustment") will terminate
25 when the Rate Proposal Docket is resolved.

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1 51. The amount of revenue collected as a result of this modification to the MGC will be
2 classified as "True-up Revenue" until a final order is issued in the Rate Proposal Docket or
3 December 31, 2008, whichever occurs first. If the Commission determines that TEP's Standard
4 Offer generation service rates shall be established by the MGC beginning January 1, 2009, then the
5 full amount of True-up Revenue shall be credited to customers over a period of 24 months through
6 a reduction in Standard Offer generation rates. If the Commission determines that TEP's Standard
7 Offer generation service rates shall be established by methods other than the MGC and a retail rate
8 decrease is ordered by the Commission, then the Company shall credit customers for the portion of
9 the True-up Revenue determined to be in excess of the new rates. The portion of such True-up
10 Revenue to be credited to customers shall equal the reduction in TEP's annual revenue
11 requirement, if any, contained in the Commission's final order, multiplied by the ratio of (i) actual
12 retail kWh sales subject to the MGC Adjustment divided by (ii) actual retail kWh sales recorded
13 during the twelve month period ending on the date a final order is issued in the Rate Proposal
14 Docket or December 31, 2008, whichever occurs first. This portion of True-up Revenue shall be
15 credited to customers over a period of 24 months through a reduction in Standard Offer generation
16 rates.

17 **C. Demand-Side Management Portfolio, Time-Of-Use Rates And Renewable**
18 **Energy Action Plan.**

19 52. TEP will file a detailed Demand-Side Management ("DSM") Portfolio, based upon
20 TEP's existing and proposed DSM programs and a Renewable Energy Action Plan ("REAP") with
21 the Commission by July 2, 2007. The DSM Portfolio, together with information regarding cost
22 recovery thereof, will be filed in a separate docket for review and approval by Staff and the
23 Commission with the objective that the Commission will ultimately approve the DSM Portfolio, as
24 well as full cost recovery for DSM outside of and separate from whatever decision is reached
25 concerning TEP's proposals to amend the 1999 Settlement Agreement. Similarly, the REAP and
26 REAP tariff will be filed in the same separate docket for review and approval by Staff and the
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1 Commission with the objective that the Commission will ultimately approve the REAP and a
2 REAP tariff that permits full recovery of the costs associated with REAP outside of and separate
3 from whatever decision is reached concerning TEP's proposals to amend the 1999 Settlement
4 Agreement. In the alternative, DSM and renewable energy issues can be fully addressed and
5 implemented in connection with the adoption of one of TEP's proposals for amending the 1999
6 Settlement Agreement in this proceeding. The Time-of-Use rates will be fully addressed and
7 implemented in connection with the adoption of one of TEP's proposals for amending the 1999
8 Settlement Agreement in this proceeding.

9 **D. Full Reservation of Rights.**

10 53. TEP's agreement to file the Rate Proposals in the Rate Proposal Docket is being
11 made for the purpose of providing the Commission, as well as the Parties and Intervenors,
12 information that has been requested to fully evaluate TEP's Rate Proposals. The Rate Proposals
13 are being presented to further settlement discussions between the parties that may result in a
14 mutually acceptable regulatory solution or agreement to modify the 1999 Settlement Agreement
15 and Decision No. 62103. TEP's filing of the Rate Proposals is with full reservation of all its rights
16 and claims, and without waiver of any of its rights or claims, arising out of the 1999 Settlement
17 Agreement and Decision No. 62103.

18 54. Similarly, the participation by Staff and the Intervenors in the Rate Proposal Docket
19 is for the purpose of gaining a better understanding of TEP's proposals for amending the 1999
20 Settlement Agreement and Decision No. 62103, and to determine whether and to what extent Staff
21 and the Intervenors may support the proposals as a means of establishing new Standard Offer
22 generation rates for TEP. Staff and Intervenors also agree that the Rate Proposals is being
23 presented to further settlement discussions between the parties that may result in a mutually
24 acceptable agreement to modify the 1999 Settlement Agreement and Decision No. 62103. Staff
25 and Intervenors' participation in the Rate Proposal Docket is with full reservation of their rights
26 and without waiver of any asserted position regarding the proper interpretation of the 1999
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1 Settlement Agreement including Staff's and Intervenors' claims that the 1999 Settlement
2 Agreement is silent as to how rates will be established beginning January 1, 2009 and TEP is not
3 entitled to charge market-based rates based upon the Retail Electric Competition Rules and the
4 impact of the Track A and *Phelps Dodge* decisions.

5 55. Any further proceedings in this Docket are stayed until further order by the
6 Commission.

7 56. The Rate Proposal Docket will be consolidated with this Docket and proceeding.

8 57. The evidence submitted in connection with the hearing on TEP's Motion to Amend
9 will be held under consideration pending further order.

10 **CONCLUSIONS OF LAW**

11 1. TEP is a public service corporation within the meaning of the Arizona Constitution,
12 Article XV, and under A.R.S. Title 40, generally.

13 2. The Commission has jurisdiction over TEP and this proceeding.

14 3. Notice of the proceeding has been given in the matter prescribed by law.

15 4. All rights and claims of TEP, Commission Staff and the Intervenors arising out of
16 the 1999 Settlement Agreement and Decision No. 62103 will be fully preserved.

17 5. It is in the public interest to preserve the status quo and prevent potentially
18 significant short term fluctuations in TEP's Standard Offer rates.

19 6. It is just and reasonable that TEP's Standard Offer rates shall remain at their current
20 level until the effective date of the Commission's final order in the Rate Proposal Docket.

21 7. The proposed modification to the calculation of the MGC for holding rates at the
22 current level is just and reasonable and should be adopted.

23 **ORDER**

24 IT IS THEREFORE ORDERED that Tucson Electric Power Company shall file the Rate
25 Proposals initiating the Rate Proposal Docket on or before July 2, 2007.

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1 IT IS FURTHER ORDERED that TEP shall file a detailed DSM Portfolio based upon
2 TEP's existing and proposed DSM programs and a Renewable Energy Action Plan ("REAP") with
3 the Commission by July 2, 2007. The DSM Portfolio and REAP, together with information
4 regarding cost recovery thereof, shall be filed in a separate docket for the purpose of
5 approving TEP's DSM Portfolio and REAP with mechanisms that permit full cost recovery of both
6 programs, outside of and separate from the Rate Proposal Docket.

7 IT IS FURTHER ORDERED that all rights and claims of Tucson Electric Power
8 Company, Staff and the Intervenors arising out of the 1999 Settlement Agreement and Decision
9 No. 62103 are fully preserved.

10 IT IS FURTHER ORDERED that Tucson Electric Power Company's current Standard
11 Offer rates for all retail customers shall remain at their current level until the effective date of a
12 final order in the Rate Proposal Docket.

13 IT IS FURTHER ORDERED that, upon expiration of the Fixed CTC, the MGC shall be
14 increased in an amount equal to the Fixed CTC in order to maintain Tucson Electric Power
15 Company's Standard Offer rates at their current level.

16 IT IS FURTHER ORDERED that the increase to the MGC ordered herein shall terminate
17 upon the effective date of a final order in the Rate Proposal Docket.

18 IT IS FURTHER ORDERED that Tucson Electric Power Company shall revise its
19 Schedule MGC-1 tariff in accordance with the terms of this Decision, and shall file the revised
20 tariff in this Docket within 30 days of the effective date of this order.

21 IT IS FURTHER ORDERED that this Docket shall be stayed until further order of the
22 Commission.

23 IT IS FURTHER ORDERED that this Decision shall become effective immediately.
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BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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CHAIRMAN

COMMISSIONER

COMMISSIONER

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL,
Executive Director of the Arizona Corporation
Commission, have hereunto set my hand and caused
the official seal of the Commission to be affixed at
the Capitol, in the City of Phoenix, this ____ day of
____, 2007.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT _____

DISSENT _____