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 And Arizonans for Electric Choice and Competition

BEFORE THE ARIZONA CORPORATION COMMISSION

8 IN THE MATTER OF THE APPLICATION OF
 9 TUCSON ELECTRIC POWER COMPANY
 10 FOR THE ESTABLISHMENT OF JUST AND
 REASONABLE RATES AND CHARGES
 11 DESIGNED TO REALIZE A REASONABLE
 RATE OF RETURN ON THE FAIR VALUE OF
 12 ITS OPERATIONS THROUGHOUT THE
 STATE OF ARIZONA.

Docket No. E-01933A-07-0402

13 THE MATTER OF THE FILING BY TUCSON
ELECTRIC POWER COMPANY TO AMEND
 14 DECISION NO. 62103.

Docket No. E-01933A-05-0650

15 **NOTICE OF FILING OF DIRECT TESTIMONY OF KEVIN C. HIGGINS**
 (2008 SETTLEMENT AGREEMENT)
 16 **ON BEHALF OF PHELPS DODGE MINING COMPANY AND**
ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION

17 Phelps Dodge Mining Company and Arizonans for Electric Choice and
 18 Competition (collectively "AECC"), hereby submits the Direct Testimony of Kevin C.
 19 Higgins (2008 Settlement Agreement) on behalf of AECC in the above captioned Docket.

RESPECTFULLY SUBMITTED this 11th day of June 2008.

FENNEMORE CRAIG, P.C.

Arizona Corporation Commission
DOCKETED

JUN 11 2008

DOCKETED BY	MR
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By: 
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**COPIES of the foregoing HAND DELIVERED
AND E-MAILED** this 11th day of June 2008 to:

Jane L. Rodda
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Arizona Corporation Commission
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COPIES of the foregoing E-MAILED
this 11th day of June 2008 to the Parties of record:

By: 

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2
3 IN THE MATTER OF THE APPLICATION)
4 OF TUCSON ELECTRIC POWER)
5 COMPANY FOR THE ESTABLISHMENT)
6 OF JUST AND REASONABLE RATES)
7 AND CHARGES DESIGNED TO REALIZE) Docket No. E-01933A-07-0402
8 A REASONABLE RATE OF RETURN ON)
9 THE FAIR VALUE OF ITS OPERATIONS)
10 THROUGHOUT THE STATE OF)
11 ARIZONA)
12 _____)

13 IN THE MATTER OF THE FILING BY)
14 TUCSON ELECTRIC POWER COMPANY) Docket No. E-01933A-05-0650
15 TO AMEND DECISION NO. 62103)
16

17
18 **Direct Testimony of Kevin C. Higgins**
19 **on behalf of**
20 **Phelps Dodge Mining Company and**
21 **Arizonans for Electric Choice and Competition**

22
23
24 **2008 Settlement Agreement**

25
26
27 **June 11, 2008**

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1 **Q. What is your recommendation to the Commission with respect to the 2008**
2 **Settlement Agreement?**

3 A. I recommend that the 2008 Settlement Agreement be approved by the
4 Commission. In my opinion, the 2008 Settlement Agreement produces just and
5 reasonable rates and is in the public interest.

6 I recommend that new rates go into effect January 1, 2009. I further
7 recommend that the greater of \$32.5 million or 50 percent of the True-Up
8 Revenues be credited to customers in the PPFAC balancing account and that TEP
9 be allowed to retain the remainder of the True-Up Revenues as part of the fair
10 resolution of the issues outstanding in this proceeding.

11 Finally, I do not support Staff's Request for a Procedural Order ("Staff's
12 Request") dated June 6, 2008, which implies that the rate increase proposed in the
13 2008 Settlement Agreement would have an impact on the special contracts
14 approved by the Commission in Decision No. 65207 and Decision No. 69873.
15 The 2008 Settlement Agreement does not state that the Signatories support
16 modifications to the power supply agreements approved by Decision No. 65207
17 and Decision No. 69873. AECC considers Staff's Request to be a unilateral action
18 taken outside the scope of the 2008 Settlement Agreement. For the reasons
19 explained in my testimony, AECC recommends that Staff's Request be denied.

1 **Overall Agreement**

2 **Q. Please provide a general overview as to why you believe the 2008 Settlement**
3 **Agreement is in the public interest and should be adopted.**

4 A. The 2008 Settlement Agreement establishes new base rates for TEP that
5 are 6.0 percent higher than current base rates inclusive of the Fixed CTC (but
6 excluding DSM-related revenues in current rates). These new proposed rates were
7 derived using conventional cost-of-service principles; as such, the agreement
8 resolves the major dispute between TEP and other parties as to the appropriate
9 basis – market or cost – for establishing Standard Offer generation rates for the
10 period beginning January 1, 2009. The resolution of this issue is a significant
11 event, as the “market versus cost” dispute had already been the subject of a fully-
12 litigated docket before the Commission in Docket No. E-01933A-05-0650.
13 Moreover, as the “market versus cost” dispute had not been resolved by the
14 Commission in that prior docket, the dispute had been carried forward into this
15 proceeding, and had the potential for continuing beyond this proceeding to the
16 courts. Resolving this issue through negotiation is a significant achievement.

17 The 2008 Settlement Agreement also provides for base rate stability over
18 the next four years, as under the terms of the agreement, the new base rates
19 negotiated in the agreement are to remain essentially fixed until January 1, 2013.
20 Taken together with the rate cap in place from 1999 until the end of 2008, the
21 2008 Settlement Agreement will extend a remarkable period of rate stability for
22 TEP customers spanning over thirteen years.

1 The 2008 Settlement Agreement also calls for the establishment of a
2 Purchased Power and Fuel Adjustment Clause (“PPFAC”) that is similar to the
3 mechanism in place for Arizona Public Service Company. This charge would not
4 be levied on low-income residential customers, nor would it apply to direct access
5 service (as direct access customers would receive their generation service from
6 suppliers other than TEP).

7 In addition, the 2008 Settlement Agreement resolves in an equitable and
8 reasonable manner numerous rate spread and rate design issues that are typical of
9 any rate proceeding. The 6.0 percent revenue increase is to be effected through a
10 6.1 percent increase on all rate schedules except low-income residential
11 customers, who shall receive no rate increase at all. This approach produces a
12 particularly favorable result for residential customers relative to cost-of-service.

13 The rate design for non-residential customers properly aligns energy-
14 related costs with energy charges and demand-related costs with demand charges,
15 minimizing cross-subsidies among non-residential customers on the same rate
16 schedules. Further, the 2008 Settlement Agreement provides for optional time-of-
17 use (“TOU”) rates for both residential and non-residential customers, giving
18 customers the opportunity to be more responsive to price signals.

19 The rate design also provides for fully unbundled rates that can
20 accommodate direct access service, consistent with the requirements of the
21 Commission’s Electric Competition Rules. As indicated in Paragraph 12.1 of the
22 agreement, the Signatories have agreed that if the Commission desires to address
23 the issue of exclusivity of certificates of convenience and necessity (“CC&N”),

1 then a generic docket is the appropriate means to do so. No change to TEP's
2 CC&N is proposed in the 2008 Settlement Agreement.

3 TEP has also committed to work with Staff and interested stakeholders to
4 develop a new partial requirements rate schedule, a new interruptible rate
5 schedule, and a new demand response rate schedule. These new rate schedules
6 would be filed within 90 days of the effective date of the Commission's approval
7 of the 2008 Settlement Agreement.

8 The 2008 Settlement Agreement also establishes a Demand-Side
9 Management ("DSM") Adjustor mechanism. The initial DSM Adjustor charge of
10 \$.000639 would be levied on all retail rate schedules.

11 Taken as a whole, the 2008 Settlement Agreement provides wide-ranging
12 resolution to most of the issues being contested in this proceeding. I strongly
13 recommend its adoption by the Commission.

14
15 **Revenue Requirement**

16 **Q. In your direct testimony filed February 29, 2008, you recommended that**
17 **TEP receive a revenue requirement reduction of at least \$3.5 million relative**
18 **to current rates, inclusive of DSM and Fixed CTC. Please explain why a 6**
19 **percent overall increase is justified in light of your original recommendation.**

20 **A.** In its Application, TEP requested a revenue increase of \$180.7 million
21 over current rates (inclusive of Fixed CTC and DSM) under its Cost-of-Service
22 Methodology scenario. TEP's proposal included a Termination Cost Regulatory
23 Asset Charge, and would have increased overall rates 23 percent over current

1 rates. In my direct testimony filed February 29, 2008, I recommended five
2 adjustments totaling \$184.2 million that would have resulted in a \$3.5 million
3 decrease relative to current revenues.

4 The 2008 Settlement Agreement provides for a \$47.1 million increase
5 over current revenues, which corresponds to a 6 percent overall rate increase. This
6 increase is justified in light of my original recommendation for the following
7 reasons:

8 (1) The \$47.1 million increase recommended in the 2008 Settlement
9 Agreement is the product of negotiation and compromise, an inherent feature of
10 any settlement agreement. To reach agreement to provide a package that is in the
11 public interest, parties must yield on some of their original positions, even if those
12 positions can be defended on a stand alone basis.

13 (2) My direct testimony recommended a \$24.0 million adjustment to base
14 rates to credit customers for 100 percent of the margins from short-term sales.
15 While my recommended adjustment is not included in the base rates established
16 in the settlement agreement, the settlement agreement does provide that customers
17 are credited for 100 percent of the margins from short-term sales as part of the
18 proposed PPFAC. Thus, my concern regarding the proper treatment of the
19 margins from short-term sales is fully addressed in the agreement – it is just
20 addressed via the PPFAC rather than in base rates. Adjusting for this
21 consideration, the revenue increase of \$47.1 million recommended in the 2008
22 Settlement Agreement is just \$26.6 million greater than I recommended in my

1 direct testimony.¹ At the same time, it is \$137.1 million less than TEP had
2 recommended in its Cost-of-Service filing in this docket.

3 (3) The 2008 Settlement Agreement provides a package of results, of
4 which the proposed revenue increase is one component. As described in the
5 overview above, this package includes favorable resolution of the “market versus
6 cost” dispute; a base rate freeze until January 1, 2013; resolution of rate spread
7 issues; improvements to rate design; increased availability of TOU options for
8 customers; and a commitment to develop new partial requirements, interruptible,
9 and demand response rate schedules. Viewed as a whole, the benefits of the
10 settlement package fully justify the compromise on revenue requirement that I am
11 making in reaching agreement with TEP and the other Signatories.

12
13 **Start of the Rate Effective Period and True-Up Revenues**

14 **Q. Section 15.1 of the 2008 Settlement Agreement states that certain issues**
15 **pertaining to the Fixed CTC True-Up Revenues remain unresolved, and that**
16 **the Signatories would present their positions with respect to when TEP’s new**
17 **rates may go into effect and how TEP’s Fixed CTC True-Up Revenues**
18 **should be calculated and treated. What is your recommendation on these two**
19 **points?**

20 **A.** I recommend that new rates go into effect January 1, 2009. I further
21 recommend that the greater of \$32.5 million or 50 percent of the True-Up
22 Revenues be credited to customers in the PPFAC balancing account and that TEP

¹ \$47.1 million – \$(3.5 million) + \$24.0 million = \$26.6 million.

1 be allowed to retain the remainder of the True-Up Revenues as part of the fair
2 resolution of the issues outstanding in this proceeding.

3 **Q. Please explain your recommendation concerning the start of the rate effective**
4 **period.**

5 A. I believe that January 1, 2009 is the most appropriate date for new rates to
6 go into effect, as it corresponds to the expiration of the rate cap established in the
7 1999 Settlement Agreement, which extended until December 31, 2008.

8 **Q. Please explain your recommendation concerning the treatment of True-Up**
9 **Revenues.**

10 A. I am very familiar with the origins of the True-Up Revenues. They derive
11 from a provision in the 1999 Settlement Agreement that requires rates to be
12 reduced by the amount of the Fixed CTC at such time that \$450 million in
13 stranded cost is recovered. I was closely involved in negotiating that provision on
14 behalf of AECC.

15 In Decision No. 69568, the Commission modified this requirement of the
16 1999 Settlement Agreement, and determined that rates would not be reduced by
17 the amount of the Fixed CTC when \$450 million in stranded cost was recovered.
18 Instead, the Decision provided that TEP customers should be protected by
19 providing for a mechanism to refund or credit the revenues, plus interest, that will
20 continue to be collected by the modified treatment of the Fixed CTC, until new
21 rates are approved. These revenues are the True-Up Revenues. In its direct filing,

1 TEP estimated that approximately \$66 million of True-Up Revenues will be
2 collected between May 2008 and December 31, 2008.²

3 The 2008 Settlement Agreement resolves the “market versus cost” dispute
4 in favor of the positions taken by Staff, RUCO, and AECC. It has been AECC’s
5 position, as expressed in my direct testimony filed previously in this case, that
6 AECC would be willing to accept a resolution in which True-Up Revenues were
7 retained by TEP under the Cost-of-Service Methodology, if, and only if, this
8 concession were accompanied by TEP’s withdrawal of all claims that the
9 Company would be harmed by setting rates at cost-of-service. The 2008
10 Settlement Agreement results in such a withdrawal of claims. Therefore, I believe
11 that in the context of the overall settlement, a result that splits the True-Up
12 Revenues between customers and the Company is reasonable. For this reason, I
13 am recommending that the greater of \$32.5 million or 50 percent of the True-Up
14 Revenues be credited to customers and that TEP be allowed to retain the
15 remainder of the True-Up Revenues as part of the fair resolution of the issues
16 outstanding in this proceeding. The crediting of the customer share of the True-
17 Up revenues to the PPFAC balancing account is the same recommendation I made
18 on page 42 of my direct testimony filed on February 29, 2008.

19 It is useful to bear in mind that when the Fixed CTC was established in
20 1999, it was not a new cost that was added to TEP’s existing rates, but a “carve-
21 out” of then-existing rates which was designated for Fixed CTC recovery. Thus,
22 when the Fixed CTC expires, removing this charge would not remove something

² Direct testimony of Kentton C. Grant, p. 11, line 23 - p. 12, line 1.

1 that was “added on” to rates, but rather removal would strip out a pre-existing
2 portion of rates. In the context of the 1999 Settlement Agreement, in which it was
3 anticipated that many customers would be shopping in competitive markets, it
4 was reasonable to expect that the Fixed CTC charge would be extinguished when
5 it had served its purpose of collecting \$450 million in stranded cost. However, in
6 the context of the 2008 Settlement Agreement, in which the Signatories believe
7 that a revenue requirement increase over current rates (inclusive of the Fixed
8 CTC) is just and reasonable going forward, and in which the “market versus cost”
9 dispute is resolved in favor of customers, a sharing of the True-Up Revenues
10 between the Company and customers is an appropriate outcome.
11

12 **Response to Staff Request for Procedural Order Dated June 6, 2008**

13 **Q. Do you have any comments with respect to Staff’s Request for a Procedural**
14 **Order dated June 6, 2008?**

15 A. Yes. Staff’s Request states that the Settlement Agreement provides for an
16 approximate six percent rate increase across all rate schedules with the exception
17 of the life line rates. Staff’s Request then goes on to state: “Such an increase
18 would have an impact on the power supply agreements approved by Decision No.
19 65207 and Decision No. 69873.”

20 Without addressing the legal aspects of Staff’s Request, I do not support
21 Staff’s Request as a matter of ratemaking policy nor do I believe that Staff’s
22 Request is called for by the 2008 Settlement Agreement.

1 The 2008 Settlement Agreement does apportion a share of TEP's revenue
2 increase to special contract customers. This has the effect of reducing the revenue
3 requirement increase for the remaining retail customers. Whether the contracts
4 that TEP has voluntarily entered with its two special contract customers allow for
5 the passing on of such a rate increase is an entirely separate matter. Based on my
6 experience with special contracts generally, it is entirely plausible that TEP's
7 special contracts do not permit TEP to pass through rate increases except as
8 already may be specified in the contract terms. TEP entered those contracts
9 voluntarily, and the Company signed the 2008 Settlement Agreement voluntarily.
10 In short, if the terms of the contracts do not permit TEP to recover the increase
11 negotiated in the 2008 Settlement Agreement, then that fact is a part of the
12 calculation that TEP management had to make in signing the agreement. It is not
13 the business of the Signatories of the 2008 Settlement Agreement to impose new
14 terms on contract customers who fairly negotiated power supply agreements with
15 TEP.

16 Assigning a share of a rate increase to special contract customers – even
17 when those increases cannot be collected under the terms of the contracts – is not
18 at all unusual in ratemaking. It is done to prevent remaining customers from
19 paying a share of the increase that would otherwise be attributable to the contract
20 customers. The utility's ability to collect any such increase assigned to special
21 contracts then comes down to the terms in those agreements. If the contract terms
22 do not permit the pass through of a general rate increase, then the utility absorbs
23 the revenue deficiency. On the other hand, if the contract specifies rate increases

1 in its own terms, then those negotiated increases are not quashed by a different
2 increase adopted in the general rate case.

3 The 2008 Settlement Agreement does not state that the Signatories support
4 modifications to the power supply agreements approved by Decision No. 65207
5 and Decision No. 69873. Indeed, AECC would not have supported such a
6 provision.

7 AECC was neither consulted on Staff's Request nor given advance notice
8 of it. AECC considers Staff's Request to be a unilateral action taken outside the
9 terms of the 2008 Settlement Agreement. For the reasons described above, I
10 recommend that Staff's Request be denied.

11 **Q. Does this conclude your direct testimony with respect to the 2008 Settlement**
12 **Agreement?**

13 A. Yes, it does.