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BEFORE THE ARIZONA CORPORATION COMMISSION

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2008 AUG 29 P 3: 56

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IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. E-01933A-07-0402
IN THE MATTER OF THE FILING BY TUCSON ELECTRIC POWER COMPANY TO AMEND DECISION NO. 62103.	DOCKET NO. E-01933A-05-0650 **STAFF'S POST HEARING BRIEF**

I. INTRODUCTION.

On July 2, 2007, Tucson Electric Power ("TEP") or the "Company" filed (i) a rate application in Docket No. E-01933A-07-0402 ("2007 Rate Application"); (ii) a Demand Side Management (DSM) Portfolio in Docket No. E-01933A-07-0401; and (iii) a Renewable Energy Action Plan in Docket No. E-01933A-07-0400. Thereafter, the 2007 Rate Application and Motion to Amend Docket No. E-01935A-05-0650 dockets were consolidated, and the Renewable Energy Action Plan was superseded by the TEP Renewable Energy Standard & Tariff Implementation Plan, approved as modified by the Arizona Corporation Commission ("Commission") in Decision No. 70314 (April 28, 2008).

The 2007 Rate Application proposed three alternative rate methodologies: (i) the Market Methodology, (ii) the Cost of Service Methodology, and (iii) the Hybrid Methodology. TEP proposed a base rate increase of $267.57 million (a 21.9% increase) for the Market Methodology; an increase of $275.80 million (a 23% increase) for the Cost of Service Methodology, including a $158.20 million base rate increase and an additional $117.60 million for a "Transition Cost Regulatory Asset" surcharge ("TCRAC"); and a base rate increase of $212.54 million (a 14.9%

increase) for the Hybrid Methodology. The dollar amounts are for base rate increases on 2006 test year adjusted revenues that exclude DSM and the Fixed CTC. The percentage increases listed above are from TEP's 2006 test year revenue that includes DSM and the Fixed Competition Transition Charge ("Fixed CTC") revenue.

A number of parties intervened, including the Arizonans for Electric Choice and Competition and Phelps Dodge Mining Company (collectively, "AECC"); Arizona Community Action Association ("ACAA"); U.S. Department of Defense and all other Federal Executive Agencies (collectively, "DOD"); Arizona Investment Council ("AIC"); International Brotherhood of Electric Workers Local 1116 ("IBEW"); Mesquite Power, LLC, Southwestern Power Group II, LLC, Bowie Power Station, LLC, and Sempra Energy Solutions, LLC (collectively, "Mesquite"); the Kroger Company; Southwest Energy Efficiency Project ("SWEEP"), Arizona Public Service ("APS") and the Residential Utility Consumer Office ("RUCO") (collectively, the "Intervenors").

On February 29 and March 14, 2008, the Utilities Division of the Arizona Corporation Commission ("Staff") and Intervenors filed their direct testimony in the consolidated dockets. Staff, RUCO, and AECC each proposed establishing new base rates for TEP using cost of service. Staff proposed a base rate increase of $9.77 million from TEP's 2006 test year adjusted revenues that exclude DSM and Fixed CTC. RUCO proposed a base rate increase of $36.24 million. AECC proposed a base rate increase not to exceed $91.62 million measured from the same baseline as proposed by Staff that excludes DSM and Fixed CTC.

TEP's average retail rate of approximately 8.4 cents/kWh during the 2006 test year includes revenue for the collection of Fixed CTC. The Staff and RUCO base rate recommendations would have resulted in decreases from the Company's 2006 average retail rate of 8.4 cents/kWh, which includes revenue from the Fixed CTC. Staff, RUCO, and AECC each opposed TEP's TCRAC recommendation.

On April 3, 2008, TEP filed a notice of settlement discussions with the Commission's Docket Control center. The parties to the proceeding subsequently held settlement discussions. Because of the settlement discussions, Staff filed a motion to postpone the filing of its Surrebuttal testimony. On

April 22, 2008, Staff's request was granted, and the filing of testimony in this matter was suspended, pending the outcome of the settlement discussions.

The settlement discussions were open, transparent, and inclusive of all parties to Docket Nos. E-01933A-07-0402 and E-01933A-05-0650 who desired to participate. All parties to those dockets were notified of the settlement discussion process, were encouraged to participate in the negotiations, and were provided with an equal opportunity to participate.

On May 29, 2008, TEP, Staff, AECC, ACAA, DOD, AIC, IBEW; Mesquite and the Kroger Company (collectively, "Signatories") entered into a Settlement Agreement ("Agreement"). RUCO was not a signatory. RUCO was invited to and actually attended a significant number of settlement discussions, but decided very early on that it would not sign the Agreement and declined to participate in the settlement process. SWEEP chose not to execute the Agreement, but indicated its support during the hearing.

The purpose of the Agreement is to settle all issues presented by Docket Nos. E-01933A-07-0402 and E-01933A-05-0650 in a manner that will promote the public interest. The Signatories agree that the terms of the Agreement are just, reasonable, fair, and in the public interest in that they, among other things, (i) establish just and reasonable rates for TEP's customers; (ii) promote the convenience, comfort, and safety, and the preservation of the health, of the employees and patrons of TEP; (iii) resolve the issues arising from the consolidated dockets; and (iv) avoid unnecessary litigation expense and delay.

II. BACKGROUND.

In 1999, TEP, AECC, ACAA, and RUCO entered into a Settlement Agreement (the "1999 Initial Settlement Agreement") regarding various issues arising out of the Electric Competition Rules, enacted by the Commission as A.A.C. R14-2-1601, et. seq. The 1999 Initial Settlement Agreement, provided for, among other things (i) the commencement of retail electric competition in TEP's service territory; (ii) TEP to recover stranded costs; (iii) the resolution of litigation related to the Commission's Electric Competition Rules; (iv) implementation of two rate reductions; and (v) a freeze on rate increases until December 31, 2008 (the "rate freeze").

In November 1999, the Commission modified and approved the 1999 Initial Settlement Agreement in Decision No. 62103. Thereafter, on December 28, 1999, the parties filed an amended, final Settlement Agreement (the "1999 Settlement Agreement"), reflecting the changes made by the Commission.

In 2002, the Commission issued Decision No. 65154 (September 10, 2002) ("Track A") Track A resolved, among other things, the issue regarding the divestiture of generation assets. Track A modified portions of Decision No. 62103 by requiring TEP to cancel any plans it had to divest any of its generation assets. The Commission took this action in response to ongoing concerns about the benefits of and the transition to competition. (*See e.g.* Decision No. 65154 at 22)

On September 12, 2005, TEP filed a Motion to Amend Decision No. 62103 (the "Motion to Amend"). The Motion to Amend sought resolution of a dispute that had arisen over how TEP's generation rates should be determined beginning January 1, 2009.

In Decision No. 69568 (May 21, 2007), the Commission ordered (i) that TEP file rate proposals by July 2, 2007, to be effective after the termination of the rate freeze, thereby initiating a Rate Proposal Docket; (ii) that the Rate Proposal Docket be consolidated with the Motion to Amend; (iii) that the operation of TEP's Fixed CTC, established under the 1999 Settlement Agreement, be extended, subject to credit, refund, or other mechanism, until the effective date of the Commission's final Order in the Rate Proposal Docket; and (iv) that TEP file a detailed DSM Portfolio and Renewable Energy Action Plan in separate dockets by July 2, 2007.

III. THE SETTLEMENT AGREEMENT IS IN THE PUBLIC INTEREST AND SHOULD BE ADOPTED BY THE COMMISSION.

A. <u>Overview of Settlement Process.</u>

It is no small feat to draft a settlement agreement among 13 parties, who represent a range of interests from consumer representatives to merchant plants, large customers of TEP to demand side management advocates. From the outset, all parties were invited to participate. The settlement process took place over 8 weeks, and had solid participation from most of the Intervenors. The process was transparent and open. Each participant was given a chance to advance its positions on

behalf of its respective client. Under questioning from Judge Rodda, the DOD witness, Dan Neidlinger, testified that the negotiations were intense, but fair and open. TR 419:20-25; 419:1-2.

It is Staff's position that the Agreement is fair, balanced and in the public interest. Ex S-3 at 6:25-26. Among the benefits are: (i) a four year moratorium on base rate increases; (ii) no base rate increase for low-income customers, (iii) the limitation of the base rate increase to approximately 6%; (iv) expanded time-of-use options for customers; (v) the establishment of a demand-side management adjuster and performance incentive; and (vi) retention of cost of service rate making treatment. (Ex S-3 at 8:1-10)

Staff also believes that the Agreement is fair to TEP. Ernest Johnson, Utilities Director, testified that the Agreement provides TEP an opportunity to earn revenues sufficient for the utility to provide reliable electric service and to achieve a reasonable profit. The Agreement would provide TEP with revenues that would allow it an opportunity to earn an overall rate of return of approximately 5.64% and a 10.25% return on equity. Ex. S-3 9:17-22.

TEP also agrees that the Agreement is in the public interest. James Pignatelli, Chairman, President and Chief Executive Officer of Unisource and TEP, testified that the Agreement is reasonable and produces just and reasonable rates. TR 108:14-15. Mr. Pignatelli further testified that the Agreement benefits shareholders, customers and employees.

During his testimony, Mr. Pignatelli asserted that shareholders would benefit by avoiding costly, time-consuming litigation regarding issues left unresolved in the Motion to Amend docket. Shareholders will see more regulatory certainty, which provides predictability, which will increase investor confidence. TR 111:13-17. Customers will benefit from the continuation of safe, reliable service by the implementation of just and reasonable rates that will be provided for by the Agreement. TR 108:17-18. Low income customers will benefit because there will be no increase passed on to them and in addition, low income customers will have the ability to chose a time–of- use tariff that is compatible with their life style. TR 108-22-25; 109:2-7. TEP's employees will also benefit.

Other Signatories also testified that the Agreement is in the public interest. Mesquite's interests revolve around ensuring that TEP will remain a viable, creditworthy purchaser in the

wholesale competitive market and ensuring that the current status of retail competition is maintained. Mesquite witness Leesa Nayudu testified that TEP should be allowed an opportunity to receive revenues sufficient to allow it to be a creditworthy purchaser in the competitive wholesale market in Arizona. TEP's acceptance of a 6% increase over base rates indicates that it believes that the increase will enable it to retain the requisite creditworthiness. Mesquite was also satisfied with the resolution of the issues regarding the exclusivity of TEP's CC&N because the Agreement, in essence, preserves the "status quo" with respect to the status of retail electric competition in Arizona. Ex. Mesquite-1 at 5:5-12. Mesquite is therefore in support of the Agreement. Ex. Mesquite-1 at 3:6-17.

AECC witness Kevin Higgins testified that the Agreement is in the public interest. Ex. AECC-3 at 2:1-5. He recommended that the Commission approve the Agreement, stating that the Agreement produces just and reasonable rates. Ex. AECC-3 at 2:1-5. Mr. Higgins stated further that the Agreement resolves a major dispute regarding the appropriate methodology for establishing rates and provides base rate stability because of the rate moratorium. Ex. AECC-3 at 3:7-12; 17-19. AECC also stated that the Agreement as a package, with the resolution of the "market v cost" dispute; the rate moratorium; improvements in rate design; increased availability of time-of-use–options; a commitment to develop new partial requirements tariffs, interruptible tariffs, and demand response rate schedules, justifies the compromise that AECC was willing to make in order to support the Agreement. Ex. AECC-3 at 7:3-11.

The Kroger Company, a general service customer, supports and recommends approval of the Agreement. Stephen J. Baron testified that the Agreement's allocation of the 6.1% base rate increase across each rate schedule is reasonable and that the rate design is reasonable and consistent with the underlying cost of service. Ex. Kroger-1 at 2:13-16; 3:1-5.

IBEW testified that its supports the Agreement in its entirety. Ex. IBEW-2 at 1:13-14. Frank Grijalva testified that TEP needs to be able to attract highly skilled employees to provide safe and reliable service. TR 426:21-25; 427:1-5. The IBEW has worked with TEP to control employee benefit costs, and the Agreement will assist with relieving cost pressures on the employees. IBEW-1 at 6-7.

Cynthia Zwick intervened on behalf of low-income customers. She testified that she is in support of the Agreement because low-income customers will not be subject to the approximately 6.0% base rate increase. TR 451:211-25. She further testified that the ACAA supports the Agreement. TR 452: 5-7.

DOD witness Dan Neidlinger testified that the Agreement provides a reasonable balancing of the interests of both TEP and its customers. Ex. DOD-2 at 1:13-14. Although the DOD was less than pleased with the across the board 6.0% revenue increase, it acknowledged that the Agreement provides improvements to TEP's rate design, including increased demand charges, lower energy charges, and optional time-of-use schedules. Thus, DOD is in support of the Agreement. Ex. DOD-2 at 2:1-15.

AIC filed a Statement in Support of the Agreement, finding that it produces just and reasonable rates, is in the public interest, and should be adopted by the Commission. TR 470:8-11.

RUCO and SWEEP participated in the settlement negotiations, but neither party became a signatory to the Agreement. SWEEP witness Jeff Schlegel testified that SWEEP neither supported nor opposed the Agreement. TR 538:13-14. SWEEP's participation in the settlement negotiations focused on DSM issues. SWEEP testified that cost effective DSM programs should be designed and implemented and that existing DSM programs should be revised and expanded. TR 538:18-22. Mr. Schlegel acknowledged that TEP's DSM programs were being reviewed in a parallel docket and that Sweep was supportive of that approach and the current schedule of Commission review. TR 540:6-9. SWEEP was also supportive of the DSM adjustor mechanism proposed in the Agreement. Ultimately, SWEEP's chose not to sign the Agreement because it did not have sufficient resources to adequately research all the issues associated with it. TR 546:14-21.

RUCO's lack of participation is both puzzling and unfortunate, given its mission to represent residential ratepayers. RUCO indicated almost at the outset that it would not sign the Agreement. Nevertheless, RUCO was invited to attend each negotiating session and in fact attended a fair number. RUCO was provided with draft agreements along with other information, in spite of the fact that RUCO did not intend to execute the Agreement. RUCO indicated that, in its opinion, the Agreement is misleading to the public in its characterization of the base rate increase. RUCO

witness, William Rigsby, acknowledged that the Agreement provides benefits to TEP's ratepayers. TR 394:13 – 395:2.

B. <u>The Settlement Resolves disputed issues relating to the 1999 Settlement Agreement.</u>

TEP's acceptance of Cost-of-Service Methodology was crucial to reaching a settlement. Staff, along with RUCO and several of the Signatories, advocated for the cost-of-service methodology. Use of the Cost-of-Service methodology is consistent with Staff's understanding of Decision No. 62103 and the 1999 Settlement Agreement. As acknowledged in Decision No. 69568, Staff disputed TEP's insistence that Decision No. 62103 and the 1999 Settlement Agreement permit TEP to charge market based generation rates for Standard Offer service commencing January 1, 2009. If either the Hybrid methodology or the Market methodology were adopted, base rates would increase between $212 million to $275 million, which would be a potential percentage increase in a range of 14.9% to 23%. Under Section XIV of the Agreement, TEP agrees to waive all claims with respect to the 1999 Settlement Agreement and/or market rates for its generation upon the issuance of a non-appealable Commission decision approving the Agreement. TEP's acceptance of Cost of Service methodology serves the public interest.

C. <u>Rate Increase and Rate Moratorium.</u>

For settlement purposes, the Signatories agreed to a rate increase that would provide TEP with approximately $828.2 million of base rate revenue per year. This revenue is approximately a 6% increase over TEP's current revenue of $781.1 million (which includes $89.6 million for the Fixed CTC). The Agreement calls for a jurisdictional fair value rate base of $1.452 billion and a fair value rate of return of 5.64%. (Ex S-4:8-24). Under the cost of service methodology, TEP had requested a total base rate increase of approximately $275.8 million, which consisted of approximately $158.2 million of base rate increase and an additional $117.6 million for TEP's requested TCRAC, which TEP had requested as a separate surcharge.

Section X of the Agreement also provides for a moratorium in which TEP's base rates will remain frozen through December 31, 2012. Section XI of the Agreement also provides an opportunity for TEP to request a change to its base rates and/or adjustment mechanisms if an

emergency were to arise. An emergency is defined as an extraordinary event that is beyond TEP's control.

D. Depreciation and Cost of Removal.

TEP formed an accounting interpretation that its generation had been deregulated. Based on that interpretation, TEP had implemented certain changes that impacted its test year accumulated depreciation for TEP's generation plant. TEP had adopted Financial Accounting Standards ("FAS") No. 143, entitled "Accounting for Asset Retirement Obligations." TEP's adoption of FAS 143 reduced Accumulated Depreciation by $112.8 million to remove previously recorded Accumulated Depreciation that it had collected in rates for estimated future cost of removal through the end of 2002. TEP had also reduced subsequent accruals of depreciation expense because TEP removed the cost of removal component from its depreciation rates for generation. Ex. S-4 at 8; TR 735-736.

As a result, TEP's balance of Accumulated Depreciation had been understated. Rather than making an adjustment to test year rate base, the Agreement addresses this concern prospectively by providing for a rate case moratorium and for depreciation rates for TEP's generating plant that include $21.6 million per year on an ACC jurisdictional basis for cost of removal. Thus, during the rate moratorium period, this provision will provide future ratepayer benefit by building up the balance of Accumulated Depreciation related to accruals for cost of removal on TEP's generating plant in a manner that may have been unachievable without the Agreement. TEP had expressed concerns that, had the Commission disallowed TEP's accounting interpretation of FAS 143, TEP would be forced to write-off certain assets. Staff acknowledged that such write-offs might negatively affect TEP's financial viability, which would not be a favorable result for ratepayers. TR 671:12-23.

E. Purchased Power and Fuel Adjustment Clause.

The Agreement provides for a Purchased Power and Fuel Adjustment Clause ("PPFAC"). TEP does not currently have a PPFAC. The PPFAC is designed to allow TEP to recover its fuel costs, protecting it somewhat from the volatility of the fuel and purchased power market. As described by Staff witness Barbara Keene, TEP would file its proposed adjuster rate each year by October 31st. The filing would include forecasts of kWh sales and fuel and purchased power costs for the upcoming year. The filing would also include calculations of the true-up component. Any

interested party could make objections to the October 31st filing within 45 days of the filing. By February 1st of each year, TEP would file an update to the information that was filed in October. Any interested party could make objections to the February 1st update within 15 days. Staff would then review both filings to verify all the calculations and to make sure that the proposed adjuster rate is calculated correctly. Staff would also review the reasonableness of the forecasts. TEP would be asked to justify any significant deviation between the historical and forecasted data. Staff would also look at the impact on customers of the proposed rate. After completing its review of the February 1st filing, Staff would prepare a memorandum and proposed order either approving the proposed adjuster rate or recommending a revised rate. TR 909-911. This process is designed to enable the Commission to issue an order by April 1st.

TEP witness Pignatelli testified that TEP needs a fuel clause that will allow it to recover its reasonable costs of supplying power. TR 104:7-11. Mr. Pignatelli further testified that the PPFAC is a benefit to customers because it ensures that the customer pays only the actual prudent cost of fuel and purchased power. TR 110:16-18. TEP witness Hutchens testified that the volatile nature of the natural gas market makes it necessary for TEP to have an adjuster mechanism. Ex. TEP-4 9:9-15. Mr. Pignatelli further testified that the PPFAC was an integral part of TEP's consideration to accept the rate moratorium. TR 138:14-16. The Agreement holds low-income customers harmless from the PPFAC.

Other Signatories were supportive of the PPFAC. Mesquite supports the PPFAC because, in its opinion, it will improve the creditworthiness of TEP. TR 47:6-8. Mesquite's support of the PPFAC is conditioned upon its understanding that TEP intends to abide by the recommended best practices for procurement that were adopted by the Commission in Decision No. 70032. TR 47-20-24. AECC also supports the PPFAC. TR 586:4-8.

Several concerns were raised with the design of the PPFAC. First, it was noted that there is no cap in place to mitigate the customer impact of a spike in the cost of fuel. The TEP proposed PPFAC (with no cap) was compared to the power supply adjuster for APS (which has a cap). Mr. Pignatelli testified that TEP would be opposed to a cap because a cap would fail to send the appropriate price signals for conservation. TR 210:10-23. Mr. Pignatelli also asserted that a cap

would penalize TEP shareholders and impact TEP's creditworthiness. TR 210:24-25, 211:9-12. He indicated that TEP would be agreeable to a properly structured cap. TR 212:18-19.

Staff's positions have been consistent: Staff did not propose a cap for either TEP or APS in their respective rate cases. TEP's PPFAC, however, includes a safeguard that is not present in the APS power supply adjustor. TR 706:1-19. Under the terms of the Agreement, TEP may reset the adjustor only after such adjustment has been approved by the Commission. In Staff's opinion, while a cap may protect ratepayers from spikes in power supply costs, it can also cause the utility to carry large deferral balances. TR 709:7-11. Mr. Hutchens, on behalf of TEP, agreed with this assessment. TR 840.

It was also noted that the PPFAC does not include a 90/10 sharing arrangement, unlike the PSA for APS. Staff witness Ralph Smith testified that, because the PPFAC is a recovery mechanism for actual costs, a sharing arrangement could result in TEP retaining 10% should costs go down. Further, in Staff's opinion, the proposed PPFAC offers incentives to TEP, such as the emission credits and the 90/10 sharing on wholesale trading, which would provide TEP with an incentive to secure its fuel needs more competitively. TR 789:6-24. Mr. Hutchens expressed concerns regarding a sharing arrangement. First, the use of the 2006 base year cost would be problematic because of the expectation of higher prices in 2009 for fuel. He opined that a sharing arrangement would not allow TEP to recover its prudently incurred costs. Further, in the event that prices go down, customers have the potential for paying more than TEP's actual cost under a sharing arrangement. TR 842-843.

F. <u>Rate Design.</u>

Successful rate designs must balance the overall design goals of utilities, customers, regulators, and other stakeholders. While recovery of the utility revenue requirement is a priority underlying the rate design, other important goals include stable rates for customers, stable and sufficient revenues for the utility, fair apportionment of costs among customers, social equity, promotion of cost-effective load management and energy conservation, investment in energy efficiency, simplicity of understanding for customers, and ease of implementation for utilities. The

Agreement proposes an overall rate design with key features that address each of these goals. TR 108:17 to 109:24; TR 336:12 to 337:18.

One of the most significant aspects of this Agreement is the provision for a rate moratorium, whereby TEP cannot seek any change to its base rates that would take effect prior to January 1, 2013. Ex. TEP-1 at ¶ 10.1. This clause guarantees a rate freeze for a minimum of four years, giving customers an extended period of rate stability. TR 336:18-19, 350:13-23.

While a moratorium provides considerable stability for the ratepayers, it can also impact the ability of the utility to collect sufficient revenues when an extraordinary event occurs or when significant costs increase. The majority of TEP's expense risk is represented by increasingly volatile fuel costs. TR 116:14-19; TR 201:22-25. To ensure there are adequate revenues to address circumstances that are out of the utility's control, the Agreement also includes an Emergency Clause and a provision for a Purchased Power and Fuel Adjustor (addressed in more detail in Section XX). Ex. TEP-1 at ¶ 7.1, 11.1.

The proposed revenue allocation, combined with the inclining block rate structure, provides for fair apportionment of costs across all customer rate schedules. The Agreement proposes that the approximate 6% increase in base rate revenue will be spread equally across all customers, with each rate schedule receiving the same percent increase, except for those residential customers who qualify for discounted low-income or "lifeline" programs. Ex. TEP-1 at ¶ 16.1, 16.28; TR 880:1-5.

While DOD did not agree that the resulting rate spread is consistent with the relative cost-of-service for each customer class, DOD believed that any disparities are outweighed by the benefits of the other rate design elements. TR 408:15-19; TR 586:9 to 587:6. For example, the non-residential rate design appropriately aligns the charges for energy and demand with their related costs, minimizing cross-subsidization among customers within the same rate schedule. Ex. TEP-6 at 9:20-22; TR 410:16-18; TR 586:19-23.

As noted, the qualified low-income customers, both existing and future, will be held harmless from the rate increase. A new set of stand-alone tariffs was created specifically for the low-income customers. These new tariffs both retain their discounts and shield them from the rate increase. TR 890:5-10, 899:13-25. Additionally, these customers will not be subject to the Purchased Power and

Fuel Adjustor. Ex. TEP-1 at ¶ 16.31; TR 880:1-5. Further, the first tier of the new inclining block rate structure provides a lower base rate for electricity consumption up to 500 kilowatt hours (kWh) per month. TR 109:2-3. These small users, which include many of the low-income customers, are less likely to be able to implement major conservation measures. The combined effects of the discounted low-income rates, which will not experience a rate increase nor be subject to the fuel adjustor, and the lower base rates for the first tier are an effective way to assist the low-income households to meet their essential energy needs.

The time-of-use options and the inclining block or inverted rate structure, in addition to encouraging conservation (as discussed below), properly reflect a fair apportionment of costs. During on-peak hours, when customer demands for electricity are highest, the cost of providing electricity is greater than at shoulder and off-peak hours, when customer demand is lower. Under time-of-use rates, customers are charged according to the period in which they use electricity, thus more fairly and accurately reflecting the actual cost to provide service during the high-cost peak periods. Mr. Pignatelli testified that ten percent of TEP's highest usage residential customers use more electricity than the fifty percent with the lowest usage. TR 110:4-9. Staff witness Frank Radigan testified that under inverted rates, customers that consume more electricity are charged rates that increase in blocks as their rates of consumption increase. Ex. S-6 at 2:19-20, 3:10-1; Ex. TEP-1 at ¶ 16.3. Therefore, according to TEP, larger users, especially those who are not on a time-of-use plan, will appropriately pay a premium for the demand placed on the system. TR 388:6-9. Additionally, both inverted rates and time-of-use rates are seasonally differentiated, so that charges during the summer reflect the higher costs of power during that high-usage period. Ex. S-6 at 3:4-6; Ex. TEP-1 at ¶ 16.14.

Mr. Radigan testified that conservation is one of the best ways to help meet the growing demand for electricity. Ex. S-6 at 7:7-8. Retail electricity rate structures and price levels influence customer consumption, and thus are an important tool for encouraging the adoption of energy-efficient technologies and practices. Any rate increase can be a challenge to customers; however, customers can reduce the impact of these increases by changing a few habits and conserving electricity. The Agreement's proposed rate design incorporates multiple features to help reduce peak

loads, increase supply security, and encourage investment in energy efficiency and renewable resources.

TEP testified that the inclining block rate structures are designed to encourage customers to conserve electricity and pursue energy efficiency. TR 109:10-14. Staff witness Radigan agrees that, under inverted rates, customers that consume more electricity are charged rates that increase in blocks as their rates of consumption increase. Ex. S-6 at 3:1-2. According to Mr. Radigan, this pricing (the more you buy, the higher the unit price) gives the right pricing signal to customers and is an effective way of changing behavior. Ex. S-6 at 3:2-3. The general service rate will have a two-tiered structure, and the residential rate proposes a three-tiered structure, seasonally differentiated, to encourage conservation not only year-round but especially during high-use summer months. Ex. S-6 at 2:19 to 3:16. In addition to promoting decreased energy use and load-shifting, higher prices during the higher cost peak season encourage investment in energy-efficient appliances, such as air conditioning units, or in renewable energy sources, such as solar tiles. Additionally, for the large commercial and industrial customers, demand charges will be increased relative to energy charges, thus promoting increased load factor and reduced peak demand. Ex. TEP-6 at 9:18-25; TR 872:1-24.

Under time-of-use rates, customers have the opportunity to lower their energy costs by reducing electric use during the high-cost peak periods. The Signatories support this important energy conservation incentive and, as such, have expanded the selection and availability of time-of-use options. Ex. TEP-1 at ¶ 16.7; Ex. S-6 at 3:19-24. The Agreement proposes three new residential time-of-use schedules that maximize the options available so that customers can choose rate schedules that best fit their lifestyle. Ex. S-6 at 7:6-13; Ex. TEP-1 at ¶ 16.10, 16.11, 16.12. The non-residential time-of-use rates incorporate peak demand charges, balancing demand and energy and properly reflecting utility costs. Ex. S-6 at 6:1-4; TR 410:10-21.

The proposed time-of-use rate schedules are all offered on an optional basis. Ex. TEP-1 at ¶ 16.7. Time-of-use, while extremely important and effective, is just one of a number of tools available to conserve energy and reduce costs. It should be used in conjunction with other tools, such as demand-side management and other real-time pricing options. TR 391:19 to 392:10.

Voluntary time-of-use gives customers an opportunity to control their bills and an incentive to reduce peak usage in a way that fits their distinctive lifestyles. Giving customers control provides the motivation for them to be successful in implementing time-of-use effectively and reducing peak demand. Mr. Johnson testified that educated customers, supplied with the necessary resources, can choose and utilize the time-of-use option that best works for them. TR 336:17-24, 387:15-17.

Staff is however, opposed to a mandatory time of use requirement. While a mandatory time-of-use requirement may achieve substantial peak load relief, it could result in large bill increases for users that cannot change their usage pattern. For example, as Mr. Johnson pointed out, there are some customers, who have unusual work schedules or other unique circumstances, for whom the time-of-use options simply would not work. TR 387:7-17. Staff believes that, under the inclining block structure, non-time-of-use customers would not be subsidized by those who are on time-of-use schedules, but rather would be paying for any increased consumption or demand placed on the system. TR 388:6-16.

Staff believes that it may be possible that a voluntary time-of-use program may not achieve the optimum levels of participation or realize the desired conservation goals, and a mandatory program could then be considered. TR 391:3-5. However, there should first be an opportunity for educated consumers to achieve those goals through informed economic decisions and appropriate, voluntary participation. TR 391:5-8.

Peak demand management is largely influenced by the quantity or patterns of energy use as consumed by end users. The Signatories support the implementation of an appropriate Demand-Side Management portfolio, and the Agreement provides for a flexible and timely cost recovery mechanism. Ex. S-7 at 3:22 to 4:17; Ex. TEP-1 at ¶ 9.1, 9.2; TR 919:19-922:19. Additionally, to encourage investment in effective DSM programs, the Agreement implements a performance incentive that allows the customers and the utility to share in the overall net benefits of the DSM portfolio. Ex. S-7 at 5:4-24.

The Agreement's rate design includes the establishment of a Renewable Energy Standard and Tariff Adjustor mechanism in support of TEP's approved plan under the Commission's directive that

the utility incorporate an increasing amount of renewable energy into its mix of electricity resources. Ex. S-7 at 2:6-16; TR 107:13; Ex. TEP-1 at ¶ 8.1.

Other tariffs to be filed pursuant to the Agreement will facilitate renewable energy projects and self-generation, as well as help reduce critical demand. These include new partial requirements tariffs, an interruptible tariff, and a demand response program tariff. Ex. TEP-1 at ¶ 18.1. Staff indicated that it would endeavor to encourage the drafting of a partial requirements tariff sooner rather than later. TR 685:12-23.

The challenge for promoting energy efficiency is balancing the desire for rates that provide the right signals to customers with the need to have rates that customers can understand, and to which they can respond. Rate designs that are too complicated for customers to understand will not be effective at promoting efficient consumption decisions. However, rate designs with clear and meaningful price signals, coupled with good customer education, can be powerful tools for encouraging energy efficiency. The proposed rate structure accomplishes these goals in several ways.

If customers are to take advantage of the potential savings offered by shifting usage to off-peak hours, time-of-use rates must be easy to compare with non-time-of-use rates. Ex. S-6 at 7:21-23. As proposed in the Agreement, each time-of-use option has the same inclining block structure as the comparable non-time-of-use schedule. Ex. S-6 at 7:23-24. Also, rates for shoulder periods are approximately the same as non-time-of-use rates, making it easier for customers to evaluate potential cost savings through load-shifting. Ex. S-6 at 8:1-5; TR 870:2-6. Further, TEP is committed to implementing a program to educate customers and promote the time-of-use rates. Ex. TEP-1 at ¶ 16.9; TR at 871:7-10, 892:15-20.

The key features of the proposed rate design effectively balance the overall goals of the Signatories as well as the ratepayers. The design provides stable rates, fairly allocates the costs, protects the low-income customers, and promotes energy conservation and efficiency. It is significant that, even RUCO, who did not support this Agreement, has unequivocally stated support for all of the key features of the proposed rate design structure. TR at 934:13 to 935:2, 957:13 to 958:10, 981:18 to 982:1; TR 1085:16 to 1086:6.

IV. CONTESTED ISSUES.

Unfortunately, the Agreement did not resolve all issues. The remaining issues to be resolved are the treatment of the Fixed CTC True Up Revenue and the effective date of the rate increase.

A. Staff recommends that TEP credit the Fixed CTC True Up Revenue against the PPFAC.

The Fixed CTC was a part of a mechanism designed to allow TEP to recoup stranded costs associated with the transition to retail competition. The Fixed CTC was intended to allow TEP to recover regulatory assets and market generation costs of $450 million. (Decision No. 62103 at 5). The Fixed CTC was supposed to terminate after $450 million had been collected or on December 31, 2008, whichever occurred first.

In Decision No. 69568, the Commission decided that the Fixed CTC should continue until the resolution of TEP's forthcoming rate case. The Commission found that it was necessary to continue the Fixed CTC in order to avoid customer confusion and disruption that may arise if rates decline for six months and then increase, and that the continuation was in the public interest. (Decision No. 69568 at 16). The amount of revenue collected as a result was designated "true up revenue" and would accrue interest and be refunded at an appropriate rate of interest. The Decision ordered that the mechanism to effect a refund or a credit would be decided upon in this docket. TEP has estimated that there is $66 million in True Up revenue. TR 112:20.

TEP argues that it should be allowed to retain the entire amount of the Fixed CTC True Up Revenue because rates were never increased to cover the Fixed CTC and should not be effectively lowered with a credit. TR 133:1-7.

AECC recommended that 50% of the Fixed CTC true up be credited against the PPFAC. TR 591-593. AECC reasoned that, since TEP has relinquished its claim of a regulatory asset, TEP should be allowed to retain some of the True Up Revenue. TR 592:21-593:3. DOD recommended that the entire amount be credited against the PPFAC, reasoning that the True Up Revenue represents an over-collection from customers and thus should be returned to the customers. TR 412:22-25; 413:1-4. AIC recommended that TEP be allowed to retain the entire amount, arguing that the Decision in this Docket would replace the 1999 Settlement Agreement and that it is matter of fairness

to not just select some portions to remain viable. TR 480:14-25. SWEEP did not reach a position on the treatment of the Fixed CTC True Up Revenue. TR 555:6-19. Mesquite did not offer any testimony during the hearing concerning the treatment of the Fixed CTC True Up Revenue.

It is Staff's position that the Fixed CTC True Up revenue should be credited in accordance with the Commission's decision. TR 342:1-23. In the event that the Commission orders a credit of the True Up Revenue, TEP indicated that it could either invest the amount in renewables or credit it against the PPFAC. TR 175:8-22.

B. <u>Rates Should Become Effective January 1, 2009.</u>

The remaining disputed issue is the effective date of the new rates. Staff contends that, as was contemplated by Decision No. 62103, rates are to become effective January 1, 2009. TR 343:1-4. This position is supported by AECC. TR 59:3-4. DOD indicated that it would rather see new rates implemented sooner rather than later, as would AIC, and IBEW. TR 420:19-25; TR 470:12-15; TR 448:17-25.

TEP makes the argument that, because the Agreement "supersedes" the 1999 Settlement Agreement, new rates can become effective as soon as possible. While TEP has waived its claims under the 1999 Settlement Agreement, there is no language in the present Agreement that extinguishes or supersedes the 1999 Settlement Agreement. TEP's assumption in this regard is simply not supported by the language of the present Agreement. Ex. TEP-1. Decision No. 62103 contemplated that rates set under the 1999 agreement would stay in effect until December 31, 2008.

V. RUCO.

RUCO indicated very early in the settlement process that it would not be a participant in the negotiations or a signatory to the Agreement. Yet RUCO staff was invited to settlement discussions and continued to attend these negotiation sessions. The testimony by RUCO witness William Rigsby, in opposing the Agreement (which was later changed to "*Comments* regarding the Settlement Agreement"[1]) implies a deliberate attempt by the Signatories to mislead the Commission regarding the percent of the base rate increase as set forth in the Agreement. Staff submits that an examination of the terms of the Agreement flatly contradicts these claims.

[1] Ex. RUCO-2 (emphasis added).

RUCO states that it became convinced early on that a settlement that would be in the best interests of residential ratepayers could not be reached. Ex. RUCO-2 at 2. RUCO further asserts that the Agreement does not result in just and reasonable rates. Ex. RUCO-2 2:14-17. Yet Mr. Rigsby testified that RUCO is in support of a substantial portion of the Agreement, including the expanded time-of-use tariffs, the expanded demand-side management program and spending, the four-year rate case moratorium, the equitable rate spread, a rate increase exemption for low income tariffs, customer credits for short-term sales revenue, the credit for 10 percent of wholesale trading profits, and customer credit for 50 percent of the revenues realized from the sale of SO2 emission allowances. TR 934:13-23. Under questioning from counsel for AECC, RUCO further admitted that it was in support of the adjuster clauses for DSM and renewable energy programs. TR 949:20-15; 950:1-3.

It appears that RUCO's chief allegation is that the full impact of the rate increase was not disclosed. TR 9336:13-15. Mr. Rigsby testified that it was RUCO's opinion that, to better inform the public, the Agreement should have expressed the increase as 19.8% over the current base rates without the Fixed CTC. TR 971:6-16. One would have hoped that, as the Agreement was being drafted, RUCO would have offered its position on how to present the rate increase. In light of the fact that RUCO continued to attend negotiation sessions and was provided copies of each draft of the agreement, it is unclear why RUCO chose to wait until its testimony was filed to voice this concern. Furthermore, an examination of the provisions of Sections 2.3 and 2.4 clearly show that RUCO's allegations are without merit. In these circumstances, RUCO's opposition to the Agreement should be disregarded.

VI. CONCLUSION.

The Agreement contains substantial benefits for ratepayers. It also provides certain benefits for TEP that will allow the Company sufficient revenue to operate in a safe and reliable manner. Staff would urge the Commission to adopt the Agreement.

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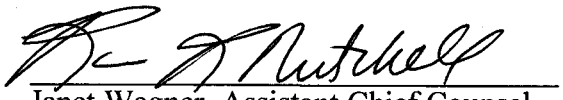
RESPECTFULLY SUBMITTED this 29th day of August, 2008.



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