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COMMISSIONERS

KRISTIN K. MAYES, Chairman
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AZ CORP COMMISSION
DOCKET CONTROL

IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE
COMPANY FOR A HEARING TO
DETERMINE THE FAIR VALUE OF THE
UTILITY PROPERTY OF THE COMPANY
FOR RATEMAKING PURPOSES, TO FIX A
JUST AND REASONABLE RATE OF
RETURN THEREON, TO APPROVE RATE
SCHEDULES DESIGNED TO DEVELOP
SUCH RETURN

Docket No. E-01345A-08-0172

**NOTICE OF FILING DIRECT
TESTIMONY (IN SUPPORT OF
SETTLEMENT AGREEMENT)
OF KEVIN C. HIGGINS ON
BEHALF OF FREEPORT-
MCMORAN COPPER & GOLD
INC. AND ARIZONANS FOR
ELECTRIC CHOICE AND
COMPETITION**

Freeport-McMoRan Copper & Gold Inc. and Arizonans for Electric Choice and
Competition (collectively "AECC") hereby submit the Direct Testimony (in Support of
Settlement Agreement) of Kevin C. Higgins on behalf of AECC in the above captioned
Docket.

RESPECTFULLY SUBMITTED this 1st day of July 2009.

FENNEMORE CRAIG, P.C.

Arizona Corporation Commission
DOCKETED

JUL -1 2009

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1 **ORIGINAL and 13 COPIES** of the foregoing
2 **FILED** this 1st day of July 2009 with:

3 Docket Control
4 ARIZONA CORPORATION COMMISSION
5 1200 West Washington
6 Phoenix, Arizona 85007

7 **COPY** of the foregoing was
8 **MAILED/OR *E-MAILED**
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26

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2
3 In the Matter of the Application of Arizona)
4 Public Service Company for a Hearing to)
5 Determine the Fair Value of the Utility)
6 Property of the Company for Ratemaking)
7 Purposes, to Fix a Just and Reasonable)
8 Rate of Return Thereon, to Approve Rate)
9 Schedules Designed to Develop Such Return)

Docket No. E-01345A-08-0172

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14 **Direct Testimony of Kevin C. Higgins**

15
16 **on behalf of**

17 **Freeport-McMoRan Copper & Gold Inc. and**

18 **Arizonans for Electric Choice & Competition**

19
20
21 **Settlement Agreement**

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25
26 **July 1, 2009**

TABLE OF CONTENTS

1
2 Table of Contents.....i
3 Introduction.....1
4 Overview and Conclusions.....2
5 Overall Agreement.....3
6 Revenue Requirement.....4
7 Revenue Spread.....6
8 Rate Design.....9
9 DSM and Self-Direction.....9
10 Interruptible Rates.....11
11 Palo Verde Life Extension.....12

1 **Overview and Conclusions**

2 **Q. What is the purpose of your testimony in this phase of the proceeding?**

3 A. I am testifying in support of the Proposed Settlement Agreement
4 (“Agreement”) filed by Staff on behalf of the Agreement’s Signatories on June
5 12, 2009. The proposed Agreement provides a comprehensive resolution of the
6 issues in the Arizona Public Service Company (“APS”) general rate case.

7 **Q. Were you personally involved in the negotiations that resulted in the**
8 **Agreement?**

9 A. Yes, I participated in the negotiations on behalf of AECC.

10 **Q. What is your recommendation to the Commission with respect to the**
11 **Agreement?**

12 A. I recommend that the Agreement as submitted by the Signatories be
13 approved by the Commission. In my opinion, the Agreement produces just and
14 reasonable rates and is in the public interest.

15 **Q. Does AECC support the entire Agreement?**

16 A. Yes. The Agreement is a package that was crafted after extensive
17 negotiations among many parties over many weeks. AECC is recommending
18 adoption of each provision in the Agreement as a package deal.

19 **Q. How is your testimony in support of the Agreement organized?**

20 A. First, I offer some comments on the overall Agreement. I follow that
21 discussion with some specific comments on certain provisions of the Agreement
22 that are of particular interest to AECC.

1 **Overall Agreement**

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

4 A. The Agreement provides a comprehensive resolution of the issues in the
5 APS general rate case. The broad scope of the Agreement is attested to by the
6 fact that it is supported by twenty Signatories with widely varying constituencies.
7 In my opinion, the Agreement strikes the appropriate balance between customer
8 interests and utility interests. Its adoption would provide APS an opportunity to
9 improve its financial condition while being fair to customers by not increasing
10 rates any more than is absolutely necessary. In support of the objective of
11 improving APS's financial condition, the Agreement commits APS to make a
12 minimum of \$700 million of equity infusions through 2014 and obligates the
13 Company to undertake best efforts to attain an equity-to-total-capital ratio of 52
14 percent by the end of 2012.

15 In addition, the Agreement resolves the important rate case issues of
16 revenue spread and rate design in a just and equitable manner. The Agreement
17 also contains major provisions addressing increased energy efficiency and
18 renewable energy development.

19 The Agreement provides a plan for base rate stability by prohibiting APS
20 from filing its next two general rate cases prior to June 1, 2011 and June 1, 2013,
21 respectively. In connection with these provisions, the Agreement also provides
22 that no new base rates resulting from APS's next general rate case will be
23 effective prior to July 1, 2012. This "stay-out" will provide customers with an

1 assurance of stable base rates for a considerable period. In my opinion, this is a
2 material benefit to customers. The Agreement also provides for the potential for
3 Systems Benefits Charges to customers to be reduced in 2012 if a Palo Verde
4 license extension is approved prior to the conclusion of the next rate case.

5
6 **Revenue Requirement**

7 **Q. What does the Agreement provide with respect to revenue requirement?**

8 A. Total base revenues (including fuel) will be set at a level that is \$334.7
9 million greater than the base rates established in APS's last general rate case.
10 [Paragraph 3.6]² However, concomitant with this change, the forward component
11 of the PSA Adjustor will be reset to zero. The net increase in rates that results
12 from the increase in base rates and the resetting of the forward component of the
13 PSA Adjustor to zero is \$207.5 million, which is comprised of an increase in non-
14 fuel base rates of \$196.3 million, plus \$11.2 million in fuel-related costs that are
15 currently excluded from PSA recovery due to the 90/10 sharing, but which are
16 properly recoverable by APS when new rates are established pursuant to a general
17 rate case. [Paragraphs 3.3, 3.4] Both the total base revenue increase of \$334.7
18 million and the non-fuel base rate increase of \$196.3 million include the interim
19 rate increase of \$65.2 million awarded by the Commission in 2008 as part of this
20 docket.

21 **Q. How does your description of the base rate increase relate to the increase of**
22 **\$131.1 million noted in Paragraph 3.2 of the Agreement?**

² References to paragraphs in brackets refer to paragraphs enumerated in the Agreement.

1 A. \$131.2 million represents the incremental increase in non-base rates above
2 the \$65.2 million increase awarded by the Commission on an interim basis, which
3 is consistent with my description above.

4 **Q. Why do you believe this revenue increase is reasonable?**

5 A. The revenue requirement recommended by the Agreement is \$103.5
6 million less than APS had requested in its Application. In my direct testimony on
7 revenue requirement, I had recommended reducing APS's requested increase by
8 \$101.5 million. As such, the reduction in APS's revenue requirement effected by
9 the Agreement and that recommended in my direct testimony are nearly identical,
10 obviously warranting my support. However, some further explanation may be
11 helpful.

12 In my revenue requirement testimony, I did not take a position either in
13 support of, or opposition to, APS's requested return on equity. Consequently, the
14 revenue adjustments in my direct testimony did not include an adjustment for
15 return on equity. Had I challenged APS's proposed return on equity, my
16 proposed reductions to APS's revenue requirement would have been greater.
17 Nevertheless, the final revenue requirement proposed in the Agreement is still
18 very close to the adjustments recommended in my direct testimony, which I
19 believe to be a reasonable result that is fair both to customers and to APS.

1 **Revenue Spread**

2 **Q. How does the Agreement resolve the issue of revenue spread?**

3 A. With two exceptions, the Agreement spreads the base rate increase across
4 all customer rate schedules on an equal percentage basis, inclusive of the interim
5 increase, and inclusive of fuel and purchase power costs that are incorporated into
6 base rates. [Paragraph 17.1] The exceptions are: (1) there will be no base rate
7 increase for low-income customers; and (2) within Rate E-32, there will be some
8 differentiation in the base rate increase among the four new rate categories of
9 Rate E-32 that are established in this case [Paragraph 17.2]. The separation of
10 Rate E-32 into four new rate schedules based on customer size – E-32-XS, E-32-
11 S, E-32-M, and E-32-L – is consistent with Staff’s recommendation in APS’s
12 previous rate case, Docket No. E-01345A-05-0816. To be clear, in the
13 Agreement, Rate E-32 *as a whole* receives the same equal percentage base rate
14 increase as all other rate schedules; as such, the differentiation of the base rate
15 increase within Rate E-32 does not impact any customers outside of Rate E-32.

16 Because the low-income customers who will receive no rate increase are
17 members of the Residential customer class, Residential customers as a whole will
18 receive a base rate increase that is slightly smaller than the overall average
19 pursuant to the Agreement. This result is shown in the “APS Rate Case
20 Settlement Proposal Bill Impact Analysis,” filed by Staff on behalf of the
21 Signatories on May 15, 2009. The table on page 2 of the document shows the
22 overall average base rate increase (including interim and fuel) to be 13.07 percent,
23 whereas the Residential base rate increase (including interim and fuel) is 12.82

1 percent. Residential customers who pay the base rate increase will pay
2 approximately the same percentage increase as the overall average.

3 **Q. What is your assessment of the revenue spread in the Agreement?**

4 A. In my opinion, the revenue spread is reasonable in the context of the
5 overall Agreement. I note that the revenue spread in the Agreement is almost
6 identical to the revenue spread recommended in Staff's direct case, which called
7 for an equal percentage increase in base rates for all rate schedules except low
8 income, inclusive of fuel costs (and inclusive of any interim increase).³

9 The revenue spread in the Agreement treats customer rate impacts on a
10 basis that is directly comparable to the measurement of class revenue deficiencies
11 in APS's cost-of-service study filed as part of APS's direct case. In other words,
12 APS's class cost-of-service study measures the base rate increase necessary –
13 including fuel – for each rate schedule to pay rates equal to its respective cost of
14 service. The base rate increase in the Agreement is measured on the very same
15 basis, i.e., base rate changes inclusive of fuel, but does not set each rate schedule
16 exactly equal to its cost of service. However, in the context of the overall
17 Agreement, this treatment is reasonable.

18 **Q. Please explain.**

19 A. APS's cost-of-service study, which was conducted in a manner consistent
20 with the Commission's directives in its decision in Docket No. E-01345A-05-
21 0816, indicates that to achieve rates equal to cost of service, the percentage base
22 rate increase (including fuel) for industrial customers (Rates 34 and 35 taken

³ Staff Exhibit FWR-3.

1 together) should be approximately equal to the system average increase – which is
2 what the Agreement provides. The study further indicates that to achieve cost-
3 based rates, the base rate increase for Residential customers (including fuel)
4 should be approximately 4.7 percent above the system average, and that rates for
5 Rate E-32 (as a whole) should be approximately 6.3 percent below the system
6 average. Within Rate E-32, the Company’s study shows that Rate E-32-L
7 warrants a much smaller increase than the E-32 average, whereas Rate E32-XS
8 warrants an increase that is above the average for the overall system.⁴ As I noted
9 above, the Agreement takes account of these differences among E-32 customers
10 by awarding a modestly smaller base rate increase for Rate E-32-L and a
11 modestly greater than average increase for Rate E-32-XS.

12 In the context of the overall Agreement, applying an equal percentage
13 increase to Residential customers (excluding low income) and Rate E-32 is
14 reasonable, in that the E-32 customers most deserving of a smaller-than-average
15 increase (E-32-L) are acknowledged through the adjustments (discussed above)
16 within E-32. With the treatment of E-32-L reasonably addressed within the E-32
17 group, I believe it is reasonable in the context of the overall Agreement for
18 Residential customers (excluding low income) to pay the same percentage base
19 rate increase as the system average, thereby mitigating, as much as reasonably
20 possible, the impact of the rate increase on Residential customers.

⁴ Source: APS Supplemental Filing: Rumolo_Direct Workpaper DJR_WP01, DJR_WP03_APS08736, APS08738.xls, Tab:”Cost of Service,” lines 1378-1379. These results are also summarized in the “Base Rate Change” column of Table KCH-2 on page 11 of my Cost of Service direct testimony.

1 **Rate Design**

2 **Q. What does the Agreement provide with respect to rate design?**

3 A. Paragraph 18.3 of the Agreement provides that the rate increases for Rates
4 E-34, E-35, and E-32-L will be implemented by adopting APS's proposed
5 customer charges along with equal percentage increases in the demand and energy
6 charges for the rate schedules. This provision ensures that, within these rate
7 schedules, higher-load-factor and lower-load-factor customers will receive the
8 same percentage base rate increase. That is, the rate increase is not biased either
9 for, or against, customers based on load factor, which is reasonable in the context
10 of the overall Agreement.

11 Paragraph 18.1 of the Agreement provides that the voltage discount for E-
12 35 customers will be adjusted by the percentage change in E-35 base rates,
13 thereby maintaining consistency with the current rate design. Paragraph 18.2
14 eliminates a proposal by APS to assign certain third-party transmission costs to E-
15 34 and E-35 customers, a proposal which I argued was unreasonable in my direct
16 testimony. Both Paragraphs 18.1 and 18.2 reasonably maintain the status quo on
17 the issues to which they pertain.

18
19 **DSM and Self-Direction**

20 **Q. Please explain the self-direction provisions of the DSM section of the**
21 **Agreement.**

22 A. Self-direction refers to a practice in which customers of sufficient size are
23 permitted to undertake their own energy efficiency measures using a portion of

1 the DSM charges that are collected directly from them. Participating customers
2 would be reimbursed for the cost of approved energy efficiency projects from
3 these funds. Self-direction programs are currently in place in Oregon and Utah.

4 As Arizona's commitment to DSM investment increases, it has become
5 increasingly important for AECC members to achieve the opportunity for self-
6 direction. Many larger customers have full-time energy personnel that direct their
7 firms' energy efficiency efforts; while these companies are committed to making
8 energy efficiency improvements, they object to subsidizing their competitors
9 through conventional DSM rate mechanisms. Self-direction provides these
10 customers with a structure for channeling their DSM charges to energy
11 improvements in their own facilities while contributing to APS's overall DSM
12 performance goals.

13 The APS Settlement Agreement approved in 2005 in Docket No. E-
14 01345A-03-0437 provided that self-direction for larger customers would be
15 studied; however, no concrete self-direction program was ever implemented. The
16 DSM provisions in the Agreement [Paragraphs 14.3 through 14.5] move forward
17 by establishing a self-direction program, the parameters of which are presented in
18 Appendix C to the Agreement. Large customers using 40 million kilowatt-hours
19 of electricity per year, aggregated over all of their APS facilities, would be
20 eligible to participate. The self-direction program is structured as a "use it or lose
21 it" proposition. Customers who enroll in the program would have two years to
22 complete approved energy efficiency projects in order to utilize the eligible DSM
23 monies recovered from them since the time of their enrollment; participating

1 customers that complete qualifying DSM projects would be able to continue
2 recovering the cost of their DSM investment for a total of ten years (or until 100
3 percent project cost recovery is achieved, whichever occurs sooner) using the
4 eligible portion of the funds recovered from them through their DSM charges.
5 Unused self-direction funds flow back into the DSM pool for use in other
6 projects. In my opinion, the self-direction option is an essential component of
7 APS's DSM efforts going forward.

8
9 **Interruptible Rates**

10 **Q. What does the Agreement provide with respect to interruptible rates?**

11 A. Paragraph 19.1 of the Agreement requires APS to work with Staff and
12 other interested parties to develop an Interruptible Rate Rider for Rate E-34 and
13 E-35 customers that will be filed within 180 days of the Commission's approval
14 of the Agreement. This provision is similar to a provision in the TEP Settlement
15 Agreement approved in Docket No. E-01933A-07-0402. If structured properly,
16 interruptible rates can be a cost-effective means for utilities to obtain reliable
17 capacity. Yet APS does not have an interruptible rider in its tariff. In my opinion,
18 it is important for interruptible service to be included in the Company's resource
19 mix, as it can provide benefits for both the Company as well as the customers
20 with the operational flexibility to perform under an interruptible rider.

1 **Palo Verde Life Extension**

2 **Q. Please describe the provisions in the Agreement dealing with Palo Verde life**
3 **extension.**

4 A. This topic is addressed in Section XI of the Agreement. The Agreement
5 provides that if APS receives Nuclear Regulatory Commission approval to extend
6 the life of the Palo Verde Nuclear Generating Station, then APS would be
7 authorized to adjust its depreciation rates used for recording Palo Verde
8 depreciation expense no sooner than January 1, 2012. This provision
9 accomplishes at least two important objectives within the Agreement:

10 (1) It provides a means through which APS can improve its net income in
11 a future period without having to increase customer rates; this occurs through the
12 authorized reduction of APS's depreciation expense that would accompany
13 approval of Palo Verde life extension. While the benefit of the lower depreciation
14 expense would be retained by APS on a temporary basis, this is comparable to
15 what occurs whenever a utility reduces expense between rate cases. When new
16 rates are established pursuant to a subsequent rate case, the full benefit of the
17 reduced depreciation expense would be flowed through to customers on a going-
18 forward basis.

19 (2) A life extension for Palo Verde would reduce the annual funding
20 requirement for plant decommissioning, which is recovered through the System
21 Benefit Charge. If Palo Verde life extension is approved, the Agreement requires
22 APS to apply to the Commission to reduce the System Benefits Charge in an
23 amount equal to the corresponding reduction in the annual decommissioning

1 funding obligation, and to reduce the Power Supply Adjustor by the amount of the
2 associated reduction in spent fuel storage costs. Such reductions would produce
3 an annual revenue requirement benefit to customers.

4 In my opinion, the treatment of Palo Verde life extension costs represents
5 a creative solution that bridges the litigation differences among various of the
6 Signatories to enable the crafting of a successful package. The provision provides
7 important benefits for customers and the Company without raising rates. I
8 strongly support its adoption along with the other provisions of the Agreement.

9
10 **Q. Does this conclude your direct testimony?**

11 **A. Yes, it does.**