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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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Arizona Corporation Commission

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IN THE MATTER OF THE GENERIC)
INVESTIGATION OF REGULATORY AND RATE)
INCENTIVES FOR GAS AND ELECTRIC)
UTILITIES)

DOCKET NO. E-00000J-08-0314
DOCKET NO. G-00000C-08-0314

**TUCSON ELECTRIC POWER
COMPANY, UNS ELECTRIC, INC.
AND UNS GAS, INC. RESPONSES
TO CHAIRMAN MAYES'
FEBRUARY 23, 2010 INQUIRY**

Tucson Electric Power Company ("TEP") and UNS Electric, Inc. ("UNS Electric") and UNS Gas, Inc. ("UNS Gas"), collectively referred to as "the Companies", hereby jointly file a response to the Arizona Corporation Commission's ("Commission") Notice of Inquiry Regarding Utility Disincentives and Potential Decoupling for Arizona Utilities ("NOI") (Docket Nos. G-00000C-08-0314 and E-00000J-08-0314 (February 23, 2010)).

The Companies support a balanced and reasoned approach for increasing the utilization of renewable energy, demand side energy ("DSM") and energy efficiency ("EE") programs, in the provision of electric service. The Companies have been, and seek to continue to be, leaders in these areas. Whether it be the construction of the solar facilities at the Springerville Generating Station, the investment in Global Solar, Inc. or the development of innovative DSM and EE programs, the Companies (and their parent, UniSource Energy Corporation) have demonstrated their willingness to embrace new initiatives that are in the public interest. The Companies have been consistent in expressing caution that new programs and technologies must be economical, viable and not harmful the financial integrity of the utility or unduly burdensome on the customer.

The NOI properly focuses on important questions that impact the ability of utilities and their customers to fully participate in DSM and EE programs. As noted in the NOI and the Companies' response, there are disincentives that currently prevent utilities and customers from

1 implementing aggressive DSM and EE programs. These disincentives can be addressed and
2 overcome. The Companies' response to the NOI provides insight into the disincentives and
3 proposed solutions.

4 For the utilities, the main disincentive is rooted in the fact that their rate recovery structure
5 is based upon fixed costs being recovered through volumetric sales. To the extent that DSM and
6 EE programs would reduce volumetric sales, without another means to recover fixed costs and
7 return on investment, the utilities will suffer irreparable harm that will negatively impact their
8 financial integrity. As detailed more fully herein, this disincentive can be overcome by
9 mechanisms that decouple the recovery of fixed costs and return on investment from volumetric
10 sales. The transition to a decoupled rate structure is essential as DSM and EE programs
11 fundamentally change the way customers use and utilities provide energy.

12 Another important factor that the Commission must weigh at this time is the TEP Rate
13 Case Settlement that (i) set TEP's rates based upon stipulated assumptions; and (ii) imposed a TEP
14 rate moratorium until January 1, 2013. This may impact the manner in which a lost revenue
15 recovery mechanism is designed and/or the timing for the implementation of DSM and EE
16 program goals and requirements.

17 The Companies are committed to working with the Commission and interested parties in
18 identifying and resolving any other issues related to the implementation of balanced and reasoned
19 DSM and EE programs that may not be addressed in the NOI.

20 The following are the Companies' responses to the specific questions raised in this NOI:

21 **1. What financial disincentives to utilities are created by energy efficiency**
22 **("EE") measures?**

23 In Arizona, rate design methods tie recovery of costs, which are primarily fixed, to
24 volumetric sales. A reduction in sales volumes or a significant reduction in the normal increases
25 in sales associated with EE programs creates the following disincentives for utilities within the
26 present ratemaking model:

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1 a. When volumetric sales decrease as a result of meeting EE standards, so will the
2 level of fixed cost recovery. This will lead to a reduction in earnings as those revenues decline.
3 The impairment of the Companies' financial health will ultimately increase costs to customers,
4 specifically through increased capital costs.

5 b. Sales decreases and/or significant reductions in sales growth will also exacerbate
6 the negative earnings impacts of regulatory lag. Rates are presently set based on historical test
7 years and it can take over two years from the end of a test year to when new rates go in to effect.
8 The increases in operating cost between rate filings have historically been partially mitigated by
9 sales growth. With the elimination of sales growth and even the possibility of sales declines, that
10 lag will place additional and unreasonable financial pressure on the Companies.

11 c. Presently, the Companies have the opportunity for earnings growth by investing in
12 plant to serve growing customer bases and greater sales volumes. The Companies need to
13 substitute those opportunities with the ability to have a reasonable opportunity for earnings growth
14 despite reduced sales volume.

15 d. The costs of energy efficiency and the associated increases in rates will also likely
16 result in declining sales. Under an inclining block rate structure, which both TEP and UNS
17 Electric presently use in their Commission approved rate structures; EE goals exacerbate recovery
18 of fixed costs because higher-use customers pay a greater portion of fixed costs. If those same
19 customers conserve energy to lessen their bills, earnings are reduced and those losses have to be
20 carried by the utility until they are recouped from all customers through future rate proceedings.

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1 **2. Should the Commission consider a decoupling or decoupling-like mechanism**
2 **that would allow Companies to recover weather-adjusted fixed costs that are**
3 **lost as a result of energy efficiency programs that drive conservation? If so,**
4 **why.**

5 The Commission should adopt a decoupling mechanism that allows companies to recover
6 fixed costs and the opportunity for a reasonable return on investment that are lost due to EE
7 programs. In the context of a decoupling mechanism, the Companies define “non-fuel revenues”
8 and “fixed-costs” as the retail revenues approved in the most recent rate case less fuel, purchased
9 power and purchased transmission revenues. Therefore, the Companies’ prefer a decoupling
10 mechanism that true-up variations in “non-fuel revenue” recovery by class to the “non-fuel
11 revenue” by class approved in the most recent rate case, as discussed further below.

12 Since fixed costs are not affected by weather, it is unclear what the Commission means by
13 "weather-adjusted" fixed costs. That said, the Companies recommend that a decoupling
14 mechanism NOT include a weather adjustment to its actual sales, primarily because weather
15 effects balance out over the long run. This alleviates the need for annual adjustments to sales that
16 may be contentious. It also stabilizes customer bills by reducing ability of a utility to over or under
17 recover due to weather variations.

18 **3. If you believe the Commission should adopt such a mechanism, how should it**
19 **be structured?**

20 In order for the proposed EE standards to be obtainable, an effective decoupler should be
21 approved by the Commission. The Companies’ preferred approach would be a mechanism that
22 allows the utility to recover its authorized fixed cost revenue recovery per customer. The easiest
23 way to avoid unnecessary conflict and confusion is to use the approved non fuel cost recoveries
24 per customer established in each Companies rate case. A well designed decoupler will compare
25 those approved fixed cost recovery levels per customer to actual results for some defined
26 measurement period and the over or under recovery will then become a regulatory asset or liability
27 to be recovered over a pre determined recovery or refund period (similar to the PPFAC and PGA

1 mechanisms of TEP, UNS Electric and UNS GAS). The proposed decoupler would track the
2 over- or under- recoveries regardless of whether conservation, weather or any other reason is the
3 cause of the change. The mechanism will also need a true-up component to allow for complete
4 refunding of over recoveries and complete billing of under recoveries.

5 In the Companies' recent response to the Notice of Proposed Rulemaking regarding
6 Electric Energy Efficiency Rules in Decision No. 71436 (December 18, 2009) – the Companies
7 proposed an interim solution to the lost of fixed cost recovery to be incorporated within the rules.
8 That interim solution is a Lost Revenue Adjustment Mechanism (“LRAM”). The Company's
9 preference would be to have the LRAM in place and recovered through the DSM rate surcharge
10 until a decoupling mechanism can be approved in a rate case.

11 Another enhancement that could be considered with a decoupler mechanism, especially for
12 the electric utilities with an inverted rate block rate design, might a “Conservation Decoupler”.
13 This mechanism would:

- 14 • Provide an added conservation incentive for residential and small commercial
15 customers by *increasing* the upper tier (higher usage) price to make up for a fixed
16 cost under-recovery (shortfall), and *decreasing* the lower tier (lower-use, “lifeline”
17 tier) to refund a fixed cost over-recovery.
- 18 • Significantly mitigate the impacts on low-use customers and those customers that
19 work hard to conserve. It would also provide a greater incentive to larger usage
20 customers to participate in conservation programs.

21 As such, a decoupler can be a rate design tool used to align customer goals, Commission
22 goals, and the goals of the utilities. For all these reasons, a decoupling mechanism should be
23 adopted.

24 **a. Should certain customer classifications be exempt?**

25 Exempting certain classes (e.g., large high load factor customers or lighting customers) is a
26 policy question for the Commission to consider. The Companies have a preference for applying
27 the mechanism to all classes with significant cost recovery variations tied to energy sales.

1 **4. How should weather-related changes in customer usage be treated? Should**
2 **they be excluded, and if so, how?**

3 As stated in response to question 2, the Companies would prefer an approach that would
4 adjust each measurement years actual fixed cost recovery per customer to the authorized fixed cost
5 revenue recovery per customer established in the most recent rate case. This would then avoid any
6 arguments or disagreements on normal within the annual decoupler proceedings.

7 **5. What mechanism should be used for recovery of unrecovered fixed costs**
8 **associated with energy efficiency? What are your views of utilizing a deferral**
9 **mechanism but requiring that accumulated costs be amortized over several**
10 **years, if deferrals are large?**

11 As stated in response to Question 3, the Companies support a mechanism that allows the
12 utility to recover its authorized fixed cost revenue recovery per customer. With respect to a
13 deferral mechanism, the Companies are not in favor of shifting cost recoveries further out and
14 creating the potential for greater costs and impacts upon future customers who may or may not
15 have benefited from the cost driver. However, the Companies are sympathetic to avoiding large
16 rate increases. If a situation arises where a one-time or a short term cost recovery for a specific
17 event or program may lead to rate shock – then the Companies might not be opposed to a
18 reasonable deferral period to smooth the impact as long as the recovery is assured and processed
19 within the decoupling mechanism.

20 **a. If the Commission were to adopt decoupling and use a deferral mechanism,**
21 **how should usage related to new customer additions be treated during the**
22 **deferral period, i.e., should it be excluded or included?**

23 As stated in response to Question 3, the Companies support a mechanism that allows the
24 utility to recover its authorized fixed cost revenue recovery per customer. This method adequately
25 addresses growth because the approved amount would be recovered from each customer added to
26 the system, and in the alternative, refunded if customer levels decline. This protects the customers
27 by insuring that they are not paying more than the approved level of fixed cost recovery in the

1 most recent approved rate case. Now, in a situation where the Company has under or over
2 recovered fixed cost per customer – that amount will be recovered or refunded based on the
3 projected sales within the defined recovery period. Since that recovery period will be forward
4 looking, similar to DSM, REST and PPFAC adjusters, the sales volumes will have anticipated
5 customer level changes calculated into them. Any deferral of charging for a portion of under
6 recovered fixed cost would just be an addition to the balance to be recovered in some future period
7 determined by the Commission.

8 **b. Should both programmatic and non-programmatic energy savings be included**
9 **in the deferrals? If so, how should non-programmatic energy savings be**
10 **measured and verified?**

11 Under the Companies' simplified approach, there is no need to identify or break-out what
12 is driving reduced or increased sales. Whether savings are due to programmatic or non-
13 programmatic causes is a non-issue as the decoupler simply balances actual fixed-cost recovery
14 against authorized fixed-cost recovery. The meets the necessary goal of breaking the connection
15 between recovery of costs and energy sales, and thereby allows a utility to promote effective EE
16 programs. This method also controls cost increases to customers.

17 **6. What features can be adopted as part of the decoupling proposal that would**
18 **prevent the Company from over-earning, or address concerns that decoupling**
19 **proposals necessarily mean deviating from the matching principle?**

20 If the decoupling mechanism is tied to the approved non fuel revenue, there should be no
21 over-earning. The utility would only be earning its allowed per-customer fixed cost revenue
22 requirement as approved in the last rate case. This also eliminates the "matching principle" issue.
23 By using the revenue requirement authorized in the last case, the adjustment to that level
24 automatically uses unit costs and unit revenues matched during the rate case process. A firm
25 "earnings cap" that doesn't allow for growth in earnings to serve additional customers, but would
26 allow for earnings to decline if customer levels declined, would however violate any "matching
27 principle".

1 **a. Should the Commission consider a “cap on earnings” as part of its approval of**
2 **the decoupling plan?**

3 No. Such a cap on earnings removes some incentive for cost-cutting and economic
4 efficiency – both of which are in the public interest. Under the decoupler, the utility will have
5 rates that are designed to recover only the Commission-approved non fuel revenue per customer
6 envisioned in the Commission order in the utility’s last general rate case. As such, customers are
7 no worse off than they would be under approved test-year adjusted assumptions.

8 **b. Should a lower return on Equity be adopted when considering rate cases for**
9 **decoupled Companies to recognize that these Companies may incur less risk as**
10 **compared to non-decoupled Companies?**

11 Whenever Return on Equity (“ROE”) is evaluated within a rate case, the level of risk will
12 be a factor in that determination. A decoupling mechanism could be a part of that consideration
13 and as such each party will have an opportunity to factor it accordingly. As decoupling
14 mechanisms are adopted in other States the returns of comparable utilities will already have
15 factored in any reduction in risk within those approved returns. Presently, many utilities
16 throughout the United States already have decoupling mechanisms and their authorized ROE’s
17 significantly exceed the authorized ROE’s of the Companies. Accordingly, a lack of a decoupling
18 mechanism in concert with the new EE standards should be evaluated with regards to its negative
19 impact on the risk of the Companies and any necessary adjustments to authorized ROE’s to
20 recognize greater risk for Arizona utilities.

21 **c. Should the Commission require periodic review of the decoupling mechanism?**

22 Yes. This is a very reasonable proposal that insures proper oversight and transparency.

23 **7. Please state whether the information provided in the Revenue Decoupling**
24 **Data Report filed in compliance with Decision 70665 supports or argues**
25 **against revenue decoupling in the case of natural gas companies.**

26 Without knowing the supporting information behind the data it is difficult to answer the
27 question, but nothing in the data appears to argue against decoupling.

1 **8. What disincentives to customer conservation may be caused by virtue of the**
2 **adoption of decoupling or decoupling-like mechanisms?**

3 Every unit of energy the customer avoids consuming through conservation efforts will
4 result in a savings to their overall energy costs. Even if 100% non fuel revenue recovery is affected
5 through a decoupling mechanism, the customer will still save between 70% and 40% of the total
6 cost associated with each unit of energy consumed. Any customer interested in conserving energy
7 will still realize a savings and should therefore be further encouraged to conserve.

8 The Companies’ “Conservation Decoupler” enhancement will further encourage
9 conservation in that recovery dollars resulting from decoupling related adjustments will be
10 primarily loaded on the higher rate blocks and any credits will be loaded on the lower usage rate
11 blocks. This design encourages all customers to reduce usage.

12 **9. Are price signals skewed by decoupling, and if so, how?**

13 If designed correctly it will offer more accurate pricing signals than current rate design.
14 The prices will be more closely aligned with the actual cost of providing the service.

15 **10. What type of revenue decoupling mechanism is appropriate for Arizona or**
16 **does it vary by Company with different facts?**

17 The Companies’ proposal is based on non fuel revenue recovery per customer. Different
18 decoupling structures could be considered for different utilities.

19 **a. Revenue per Customer?** Revenue-based adjustments (a and d) are inappropriate
20 because the fuel component is captured through the PPFAC and should be
21 eliminated from the decoupler. Fuel and purchased power does not need to be
22 addressed through the decoupling mechanism.

23 **b. Sales margin per Customer?** Sales margin (non-fuel revenue) per customer is by
24 far the most preferred method. It allows for the best alignment with the level of
25 revenues approved in the most recent rate case. It also allows for appropriate
26 recovery even with tiered rates.

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1 **c. Total margin revenue?** Total margin (non-fuel revenue) would be unacceptable as
2 it would not allow for cost recovery associated with increases in customer levels
3 and would lead to significant and harmful revenue erosion if high growth were to
4 come back to our service territories.

5 **d. Total Class Revenue?** Total Class Revenue based adjustments, as mentioned in (a)
6 above, are inappropriate because the fuel component is captured through the
7 PPFAC and should be eliminated from the decoupler. Fuel and purchased power
8 does not need to be addressed through the decoupling mechanism.

9 **e. Usage per customer?** Usage per customer (“UPC”) is overly simplistic and
10 problematic in that it does nothing to account for the fact that TEP and UNS
11 Electric have tiered rate structures. If you established that the average UPC for a
12 customer class is “x” then apply that to our tiered rate structure - it would not
13 equate to the appropriate fixed cost recovery level. This could result in the under
14 recovery of fixed cost to be overestimated resulting in Customers being unfairly
15 charged too much.

16 **11. Should the Commission impose penalties for failure to meet specific designated**
17 **DSM goals?**

18 No. The Utility does not have the authority to impose customer participation and cannot
19 deny service to new customers. Despite the aggressive goals of the Commission and the
20 Companies’ best efforts - EE goals may not be met. One significant customer could offset several
21 years of DSM program reductions in terms of increasing sales.

22 **a. Should the opportunity to have periodic rate adjustments be tied to meeting**
23 **specific energy efficiency requirements?**

24 This question would be more appropriately addressed in EE dockets as program
25 effectiveness and customer adoption is an EE program issue, not a decoupling issue. A decoupling
26 mechanism is designed to remove the disincentive to implement EE programs. Even marginally
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1 performing EE programs will result in under recovered fixed costs for a utility and said utility
2 must be allowed to recover those costs.

3 **12. What means should be employed to track conservation associated with specific**
4 **DSM programs for purposes of evaluating the success of decoupling?**

5 DSM programs should continue to be evaluated each year, with regards to their
6 effectiveness and economic viability. Evaluating the success of decoupling should be based on the
7 program's effectiveness at allowing utilities to be aggressive participants in the energy reduction
8 process while retaining their financial health and with reasonable rates as an end result. That
9 evaluation should be on-going and can be reconsidered in each rate case and/or DSM filing.

10 **13. What mechanisms are needed to insure data quality and accuracy of**
11 **forecasting customers, usage, and utility driven energy efficiency savings?**

12 Most of the existing programs already require the cost and participation data to be retained.
13 While the Company's believe the information should be retained and appropriate data reported to
14 track not only participation and costs, but where possible quantify any true changes in usage trends
15 and other trends as needed. Current data information systems and reporting mechanisms should be
16 utilized rather than imposing additional reporting burdens and related system costs. Conservation
17 is already an expensive venture, adding costs just to keep more data could be considered counter-
18 intuitive.

19 **14. Should decoupling mechanisms include a low-income component?**

20 Low-income customers are heavily subsidized as it is; careful consideration must be given
21 before deciding to subsidize EE programs as well.

22 **a. Should utility energy efficiency programs be structured to align costs and**
23 **benefits among rate classifications?**

24 The costs and benefits of conservation and energy efficiency programs should be
25 transparent, so that all customers know the costs of the programs and how the cost burden is being
26 shared. Transparency is especially important because conservation and energy-efficiency
27 programs are often cost-justified by economic externalities.

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15. What additional issues should the Commission consider when addressing utility disincentives to implementing its Energy Efficiency requirements?

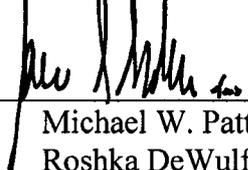
EE and DSM programs should be considered by the Commission to be similar to other traditional supply side resources. In a utility's resource portfolio, EE and DSM programs are analogous to traditional supply side resources, such as a power plant. Also, from a financial perspective, EE and DSM programs require significant capital investment in necessary infrastructure and have ongoing maintenance costs, the same as a power plant. Accordingly, the Commission should authorize utilities to earn a reasonable return on, as well as cost recovery of, their investments EE and DSM programs. The Companies believe that the appropriate way to recover those expenditures and earn a reasonable rate of return is through a decoupling mechanism.

The Commission should also consider the effects of distributed generation ("DG") as prescribed in the REST and Net Metering rules on utilities. Similar to EE and DSM programs, DG reduces volumetric sale and thus, adversely impacts the ability of utilities to recover fixed costs and earn their authorized rate of return. An appropriately designed decoupling mechanism includes the effects of DSM, EE and DG programs.

If the Companies have any additional comments, they reserve the right to supplement these answers at a later date.

RESPECTFULLY SUBMITTED this 26th day of March 2010.

TUCSON ELECTRIC POWER COMPANY, UNS ELECTRIC, INC. AND UNS GAS, INC.

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