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BEFORE THE ARIZONA CORPORATION COMMISSION

GARY PIERCE, Chairman
BOB STUMP
SANDRA KENNEDY
PAUL NEWMAN
BRENDA BURNS

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-11-0224 **NOTICE OF FILING DIRECT TESTIMONY OF SOUTHWEST ENERGY EFFICIENCY PROJECT**

Southwest Energy Efficiency Project ("SWEEP"), through its undersigned counsel, hereby provides notice that it has this day filed the written direct testimony of Jeff Schlegel in connection with the above-captioned matter.

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DATED this 18th day of November, 2011.

ARIZONA CENTER FOR LAW IN
THE PUBLIC INTEREST

By _____
Timothy M. Hogan
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ORIGINAL and 13 COPIES of the foregoing filed this 18th day of November, 2011, with:

Docketing Supervisor
Docket Control
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

COPIES of the foregoing Electronically mailed this 18th day of November, 2011 to:

All Parties of Record

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COMMISSIONERS

GARY PIERCE, CHAIRMAN
BOB STUMP
SANDRA D. KENNEDY
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Direct Testimony of

Jeff Schlegel

Southwest Energy Efficiency Project (SWEEP)

November 18, 2011

Direct Testimony of Jeff Schlegel, SWEEP
Docket No. E-01345A-11-0224

Table of Contents

Introduction

Q. Please state your name and business address.

A. My name is Jeff Schlegel. My business address is 1167 W. Samalayuca Drive, Tucson, Arizona 85704-3224.

Q. For whom are you testifying?

A. I am testifying on behalf of the Southwest Energy Efficiency Project (SWEEP).

Q. Please describe the Southwest Energy Efficiency Project (SWEEP).

A. SWEEP is a public interest organization dedicated to advancing energy efficiency as a means of promoting customer benefits, economic prosperity, and environmental protection in the six states of Arizona, Colorado, Nevada, New Mexico, Utah, and Wyoming. SWEEP works on state legislation; analysis of energy efficiency opportunities and potential; expansion of state and utility energy efficiency programs as well as the design of these programs; building energy codes and appliance standards; and voluntary partnerships with the private sector to advance energy efficiency. SWEEP collaborates with utilities, state agencies, environmental groups, universities, and energy specialists in the region. SWEEP is funded by foundations, the U.S. Department of Energy, and the U.S. Environmental Protection Agency. I am the Arizona Representative for SWEEP.

Q. What are your professional qualifications?

A. I am an independent consultant specializing in policy analysis, evaluation and research, planning, and program design for energy efficiency programs and clean energy resources. I consult for public groups and government agencies; and I have been working in the field for over 25 years. In addition to my responsibilities with SWEEP, I am working or have worked extensively in many states that have effective energy efficiency programs, including California, Connecticut, Massachusetts, New Jersey, Vermont, and Wisconsin. In 1997 I received the Outstanding Achievement Award for the International Energy Program Evaluation Conference. I have testified before the Arizona Corporation Commission in many proceedings.

Q. What is the purpose of your testimony?

A. In my testimony, I will summarize the public interest in increasing electric energy efficiency; discuss why and how the Commission can increase energy efficiency opportunities to help Arizona Public Service Company (APS) customers reduce their utility bills; describe how the Company has positioned energy efficiency to become the primary energy resource to meet energy growth over the next decade; explain why energy efficiency, as a fundamental energy resource meeting the real energy needs of

customers at lowest cost, must be satisfactorily funded and provided stability by expensing a majority of energy efficiency program funding in base rates; recommend a new energy efficiency performance incentive that will better promote delivery of cost-effective energy efficiency and associated public interest benefits; stress the need for the Company to document reductions in utility system and customer costs as a result of energy efficiency and as a means to demonstrate the value of energy efficiency investments; discuss the linkage between the increased utility efforts in energy efficiency and the adoption of decoupling; comment on and support – with two exceptions – the decoupling mechanism (Efficiency and Infrastructure Account or EIA) proposed by the Company to reduce the financial disincentive to utility support of energy efficiency; propose a methodology to better account for the impacts of Commission-adopted energy efficiency policies in determining rates; describe SWEEP's support for redesigning the bill in order to lessen customer confusion and provide customers with more useful information; and urge Commission disapproval of the Company's proposed infrastructure tracker (Environmental and Reliability Account).

The Public Interest in Increasing Electric Energy Efficiency

Q. What is the public interest in increasing electric energy efficiency?

A. Electric energy efficiency is in the public interest. Increasing energy efficiency will provide significant and cost-effective benefits for all APS customers, the electric system, the economy, and the environment. Electric energy efficiency is a reliable energy resource that is less expensive than other available energy resources. Consequently, increasing energy efficiency will save consumers and businesses money through lower electric bills and the deferral of unnecessary infrastructure, resulting in lower total costs for customers. Increasing energy efficiency also reduces load growth; diversifies energy resources; enhances the reliability of the electricity grid; reduces the amount of water used for power generation; reduces air pollution; creates jobs that cannot be outsourced; and improves the economy. In addition, meeting a portion of load growth through increased energy efficiency can help to relieve system constraints in load pockets. By reducing electricity demand, energy efficiency mitigates electricity and fuel price increases and reduces customer vulnerability and exposure to price volatility. Energy efficiency does not rely on any fuel and is not subject to shortages of supply or increased prices for natural gas or other fuels.

Q. What are the estimated costs for energy efficiency savings?

A. Energy efficiency is a reliable energy resource that costs significantly less than other resources for meeting the energy needs of customers in APS' service territory. In 2010, the cost of energy efficiency programs including measurement evaluation and research (MER) and the Company performance incentive was $0.142 cents per

lifetime kWh.[1] In 2011, the planned program costs including MER and the Company performance incentive is projected to be $0.185 per lifetime kWh.[2] According to the testimony of APS witness Leland Snook, the cost of energy efficiency programs will be approximately $0.035 per kWh in 2015[3]. In comparison, the 2010 cost of new generation for other energy resources is substantially more: natural gas combined cycle generation costs between $0.082-$0.156/kWh; coal generation costs between $0.101-$0.189/kWh; and nuclear generation costs between $0.14-$0.215/kWh.[4]

Increasing Energy Efficiency to Reduce Utility Bills for APS Customers

Q. What should the Commission do to increase opportunities for APS customers to reduce their energy bills through energy efficiency?

A. In its order on the APS rate case, the Commission should require APS to meet the energy savings requirements in the Electric Energy Efficiency Standard ("EEES"); ensure that there is adequate funding to achieve the EEES energy savings requirements and attain the associated public benefits; and treat energy efficiency as the core energy resource that it is by expensing the majority of the energy efficiency program funding in base rates.

Q. What energy savings requirements should the Commission set?

A. The Commission, in approving any order that increases rates for APS customers, should ensure that the least cost resource – energy efficiency – is fully pursued, consistent with the Commission-adopted EEES, which established cumulative annual energy savings requirements to make certain that energy efficiency and all of its associated public interest benefits would be realized. Accordingly, the cumulative annual energy saving requirements set forth in the EEES should be included in any Commission order increasing APS rates. The cumulative annual energy savings requirements in the EEES are listed below (expressed as cumulative annual energy savings as a percent of retail energy sales in the prior calendar year):

- 2012: 3.00% cumulative annual energy savings
- 2013: 5.00% cumulative annual energy savings
- 2014: 7.25% cumulative annual energy savings
- 2015: 9.50% cumulative annual energy savings
- 2016: 12.00% cumulative annual energy savings
- 2017: 14.50% cumulative annual energy savings
- 2018: 17.00% cumulative annual energy savings
- 2019: 19.50% cumulative annual energy savings
- 2020: 22.00% cumulative annual energy savings

[1] Arizona Public Service Company Demand Side Management Semi Annual Report, July through December 2010.
[2] Arizona Public Service Company's 2011 Demand Side Management Implementation Plan Application.
[3] Western Resource Advocates data request 1.3
[4] Leland Snook work paper 3.

The cumulative annual energy saving requirements set forth in the EEES result in approximately the following levels of annual energy savings (expressed below as approximate annual energy savings as a percent of retail energy sales in the prior calendar year):

- 2012: 1.75% annual savings
- 2013: 2.00% annual savings
- 2014: 2.25% annual savings
- 2015: 2.25% annual savings
- 2016: 2.50% annual savings
- 2017: 2.50% annual savings
- 2018: 2.50% annual savings
- 2019: 2.50% annual savings
- 2020: 2.50% annual savings

Q. Has the Commission included energy savings requirements for energy efficiency programs in a rate case order for APS previously?

A. Yes. In APS's last rate case, the Commission similarly ordered the Company to achieve annual energy savings for customer benefit in 2010, 2011, and 2012. The Commission required APS to achieve annual energy savings from energy efficiency programs of 1.0% in 2010, 1.25% in 2011, and 1.5% in 2012, expressed as a percent of total energy resources needed to meet retail load.

In 2010, APS surpassed this 1.0% savings requirement, achieving savings equivalent to 1.05% of total energy resources. As a result of the energy efficiency programs it implemented in 2010 to meet this requirement, APS delivered more than $150 million in net benefits for customers; produced annual savings in excess of 300 GWh; generated lifetime savings in excess of 3.5 TWh; conserved more than 1 billion gallons of water; avoided more than 7 metric tons of sulfur oxide emissions; and prevented more than 130 metric tons of nitric oxide emissions.

In 2011, the Company is implementing programs that are on track to meet the 2011 savings requirement of 1.25%: as of June 2011 APS had already delivered more than $76 million in net benefits; produced annual savings in excess of 200 GWh; and generated lifetime savings in excess of 2.0 TWh. APS has also proposed an energy efficiency implementation plan for 2012 (currently pending before the Commission), which if approved, is designed to achieve the 2012 savings requirement of 1.5% and deliver substantial public interest benefits.

Q. How can adequate funding to achieve the EEES energy savings requirements be ensured?

A. APS has positioned energy efficiency to become the primary resource to meet energy growth over the next decade. From 2011 to 2020, energy efficiency will meet more

than half of APS' planned energy growth, making it the Company's largest growing energy resource for meeting load growth over the next ten years. As a fundamental resource meeting the real energy needs of customers at lowest cost, energy efficiency must be satisfactorily funded and provided stability – else the numerous public interest benefits of this core resource may not be realized. In order to provide adequate treatment for this central resource, it is critical that a total of $70 million of energy efficiency programs be expensed in base rates. Since $10 million of energy efficiency program funding is already expensed in base rates, a $60 million increase would be necessitated. The demand side management (DSM) adjustment mechanism should still remain intact, but should recover or refund any energy efficiency funding amounts above or below $70 million, as needed to implement energy efficiency programs to meet the energy savings requirements established by the EEES. In this way, the DSM adjustment mechanism would serve as a flexible means of recovering additional program funding (as needed).

Q. Has the Commission allowed energy efficiency program funding to be expensed in base rates previously?

A. Yes. In Commission Decision No. 67744, approving the settlement agreement to increase APS rates in 2005, an annual $10 million allowance for DSM costs was approved for inclusion within base rates. In 2006, the year directly following that decision, the Company spent $10.6 million on energy efficiency programs. Thus the $10 million allowance equated to more than 90% of energy efficiency program expenditures in that year. Since this time, energy efficiency has evolved to become a central energy resource meeting the real energy needs of customers at lowest cost while also delivering substantial benefits for customers, the economy, the utility system, and the environment. Moreover, as described earlier, APS has positioned energy efficiency to meet more than half of APS' planned energy growth over the next decade, making it the primary energy resource for meeting growth over the next ten years. As a core and growing component of the Company's energy resource mix and also the least expensive resource available to meet future energy needs, energy efficiency must be adequately funded and provided consistency. In its 2012 plans for energy efficiency, the Company proposes to spend $78 million on programs while delivering $194 million in net benefits to customers. Hence, expensing $70 million in base rates would equate to approximately 90% of these anticipated funds.

Q. What else should be done to increase opportunities for APS customers to reduce their energy bills through energy efficiency?

A. In addition to adequate funding for program implementation and delivery, energy efficiency programs must continue to be cost-effective, efficient, and successful and should continue to be reviewed, approved, and improved through the energy efficiency implementation plan and the semi-annual reporting processes. It is also essential that the Company continue to expand and diversify offerings so that a larger number of customers can achieve greater energy and bill savings and that it continue to develop innovative approaches to leverage ratepayer money with funds from other

sources. For example, the Company should continue to expand savings opportunities for small businesses and renters available through its Small Business and Multifamily Energy Efficiency programs, respectively; fully implement an energy efficiency financing offering for small businesses; expand its Consumer Products offerings to include additional equipment, including electronics; jointly offer and deliver programs with gas utilities as a means to achieve program delivery efficiencies and cost savings and to provide gas and electric customers with more savings opportunities and a more seamless experience; and develop programs highly tailored to certain market segments (i.e. hotels, retail stores, large multifamily properties, data centers, etc.).

Energy Efficiency Performance Incentive

Q. What is SWEEP's proposal for an energy efficiency performance incentive in this rate case?

A. Energy efficiency performance incentives have been shown to be an important tool to encourage effective delivery of cost-effective energy efficiency, and SWEEP supports appropriately designed performance incentives.

In SWEEP's view an appropriately designed performance incentive:

1. Encourages the Company to pursue cost-effective energy efficiency;

2. Is designed in such a way to avoid any perverse incentives;

3. Is based on clearly-defined goals and activities that are sufficiently monitored, quantified, and verified;

4. Is available only for activities for which the Company plays a distinct and clear role in bringing about the desired outcome; and

5. Is kept as low as possible while balancing and meeting the objectives and principles mentioned above.

SWEEP proposes that the Company's current performance incentive — a tiered performance incentive as a percentage of net benefits, capped at a tiered percentage of program costs — should be improved to be more effective while reducing any perverse incentives. To that end, SWEEP proposes that the Company's energy efficiency performance incentive be redesigned so that it simultaneously incents cost-efficiency and the delivery of a high volume of savings.

Q. What improvements in the Company's performance incentive does SWEEP propose?

A. SWEEP proposes changes to the performance incentive cap and the design of the incentive mechanism.

First, SWEEP recommends that the performance incentive cap be determined based on a percent of the goal and target incentive amount rather than on a tiered percentage of program costs. Specifically, for a performance incentive based on meeting a certain goal, for which the Company would earn 100% of its proposed incentive by meeting the target of 100% of goal, the performance incentive amount would be capped at 130% of the target incentive amount (which would be commensurate to performance at 130% of goal). For example, consider a goal of X, with a target performance incentive of Y. If the Company performs at 140% of goal (140% of X), the Company's performance incentive amount would be capped at 130% of the target incentive amount (130% of Y). The performance incentive cap would not be based on what the Company spent.

Second, SWEEP proposes a three-component performance incentive mechanism designed to encourage the company to achieve benefits for customers (the volume of benefits), to achieve the customer benefits cost-efficiently from the perspective of ratepayers (thereby enhancing value to ratepayers), and to focus on specific indicators of performance for certain key objectives or in specific market segments. Specifically, the performance incentive mechanism should consist of three components:

1. Benefits component, based on the present value (in dollars) of the achieved societal benefits of the program (45% of the total incentive amount).
2. Cost-efficiency component, based on the achieved total societal benefits minus the program costs funded by ratepayers (45% of the total incentive amount).
3. Specific performance metrics focused on specific indicators of performance for certain key objectives or in specific market segments, such as metrics for performance on financing offerings or performance in specific segments such as low income customers, multifamily customers, or small businesses (10% of the total incentive amount). The specific performance metrics should be able to be proposed, updated or modified in an energy efficiency implementation plan process.

SWEEP recommends that the performance incentive cap described above be applied to each component and metric in the performance incentive.

Documentation of Utility System Cost Reductions as a Result of Energy Efficiency

Q. How can the Commission ensure that investments in energy efficiency are reducing customer costs and the forecasted costs of the utility system?

A. As APS increases the energy efficiency investment, it must demonstrate the value of this investment in delivering public interest benefits, including reductions in utility system costs and customer costs over time as a result of lower customer loads on the utility system. As part of this rate case and in subsequent reports, APS should document in its filings before the Commission reductions in forecasted or planned

costs in meeting the needs of customers and their forecasted loads, including deferral of plant investments and a lower level of plant investments, as a result of energy efficiency expansion as required by the EEES. The Company should also include document such utility system cost reductions as a result of increased energy efficiency and reduced customer loads in its demand side management reports.

Decoupling to Reduce the Financial Disincentive to Electric Utility Support of Energy Efficiency

Q. Does APS experience a financial disincentive to its support of energy efficiency when its customers respond and become more energy efficient?

A. Yes. Traditional utility regulation links the utility's financial health to volumetric sales of electricity, resulting in a utility financial disincentive to support energy efficiency and other demand-side resources that reduce sales. Energy savings by APS customers (which are beneficial for customers, the economy, the utility system, and the environment) result in lower revenues for the Company and the under-recovery of Commission-authorized utility fixed costs. In general, this financial disincentive can reduce utility support and enthusiasm for cost-effective resources such as energy efficiency programs that minimize the long-term costs of providing service. It could also impede potentially crucial utility support for building energy codes and other policies that reduce utility bills for customers and serve societal interests.

Q. Should a decoupling mechanism for APS be implemented to reduce the financial disincentive and encourage APS to support additional increases in energy efficiency through programs and other initiatives such as support of building energy codes?

A. Yes. The financial interest of APS should be better aligned with the interests of its customers by reducing financial disincentives to utility support of energy efficiency, thereby resulting in more energy savings and larger reductions in customer energy bills.

SWEEP supports decoupling mechanisms to address issues related to energy efficiency, i.e., when such mechanisms would be effective in substantially increasing customer energy efficiency and reducing the financial disincentive to electric utility support of increased energy efficiency.

SWEEP is not in favor of decoupling solely or primarily as a mechanism for the utility to recover its fixed costs. Therefore, in SWEEP's view the implementation of decoupling is premised on substantial increases in customer energy efficiency, for which the decoupling mechanism would reduce the financial disincentive to the utility of such increased energy efficiency. Because the EEES will deliver substantial energy efficiency savings for APS customers, decoupling in this situation is justified.

Q. Does full decoupling completely and effectively reduce Company disincentives for the support of activities that eliminate energy waste, including activities not directly linked to the Company's energy efficiency programs?

A. Yes. Full decoupling completely and effectively reduces Company disincentives for the support of activities that eliminate energy waste. As such, full decoupling is important not only for full utility support of energy efficiency programs but also for activities that reduce sales but are not or may not be directly linked to the Company's portfolio of energy efficiency programs. This could include utility support for building energy codes; appliance standards; energy education and marketing; state and local government energy conservation efforts; and federal energy policies.

Q. Does SWEEP support the decoupling mechanism (Efficiency and Infrastructure Account or "EIA") proposed by APS?

A. SWEEP supports the revenue per customer decoupling mechanism proposed by APS with two exceptions:

1. SWEEP supports a true 3% cap on upward decoupling adjustments that would apply for each and every adjustment period and for which any carried-forward deferred balance would be subject. SWEEP does not support the cap proposed by the Company, which would limit the *amount of increase* in the decoupling adjustment from one year to the next to 3% of company's revenues but apparently would not apply (in the Company's EIA proposal) to the deferred balance. It appears that the Company's proposal could result in a decoupling adjustment of greater than 3% (e.g., in the event that the amount of the increase in the adjustment from one year to the next was 3% and there was a deferred balance from prior years, thereby leading to the sum of the two to be greater than 3%). The Company's proposed cap therefore would not represent a total and true cap of 3% of total company revenues per adjustment period as recommended by SWEEP and as discussed during the decoupling workshops.

2. In order to provide ratepayers with weather-related relief following extreme events, SWEEP would prefer more timely and current adjustments than the annual decoupling adjustments proposed by APS. During the technical conferences, APS explained that limitations to their billing system preclude more timely adjustments. SWEEP therefore recommends that the Commission order that any revision to or introduction of a new Company billing system incorporate capabilities that would enable more current decoupling adjustments (i.e., monthly adjustments to address weather and extreme weather events).

Q. Is the Company-proposed decoupling mechanism consistent with the Commission's Decoupling Policy Statement?

A. Yes. Together, the Company's energy efficiency portfolio – designed to meet the cumulative annual energy savings required by the EEES – and its proposed revenue

per customer decoupling mechanism are consistent with the Commission's Decoupling Policy Statement. The Company's proposal meets the following policies set forth in the Policy Statement:

- "Utilities should pursue all cost-effective energy efficiency and demand side management resources, and should meet Arizona's Electric. . . Efficiency Standard of at least 22% electric energy savings by 2020."
- "Revenue decoupling may offer significant advantages over alternative mechanisms for addressing utility financial disincentives to energy efficiency."
- "While other decoupling models are appropriate in general, non-fuel revenue per customer decoupling may be well suited for Arizona."
- "Adoption of decoupling. . . should not occur as a pilot as this insufficiently supports demand-side management efforts, discourages beneficial changes in rate design, and is unlikely to encourage financial ratings improvements."
- "Full decoupling is preferable to partial decoupling."
- "Decoupling adjustments should occur at least on an annual basis, however, parties may propose more current adjustments as this may provide ratepayers with weather related relief following extreme events."
- "Broad participation in decoupling is preferred; however, the unique characteristics of each utility may merit different treatment of some customer classes."
- "Collars or caps on decoupling adjustments should be designed to encourage gradualism, and to minimize the short-term effects on customers."

Accounting for Commission-Adopted Policies as an Adjustment to Sales

Q. Does SWEEP recommend other improvements to ratemaking practices applied in this rate case proceeding?

A. Yes. The impacts of Commission-adopted policies, including the energy savings required by the EEES, should be reflected and accounted for in the test year sales used to set rates in this proceeding. Specifically, a pro-forma adjustment to sales (which would impact revenues) should be applied to test year sales, to account for the energy savings and load-reducing effects of the Commission-adopted EEES requirements. The EEES requirements and their impacts on sales are known and measurable. Further, applying the pro forma adjustment would result in better and more accurate alignment of revenues and expenses based on these known and measurable quantities. If the Commission is concerned whether a full 100% of the EEES requirement would be met in each and every future year, the pro forma adjustment could be applied at a level of 75% of the EEES requirement.

Customer Bill Redesign and Disclosure

Q. Does SWEEP support a redesign of the APS bill?

A. SWEEP supports redesigning the APS bill in order to lessen customer confusion and provide customers with more useful information.

SWEEP would support either of the following:

1. If APS plans to simplify the bill by presenting fewer cost categories, SWEEP notes that recovering the vast majority of energy efficiency through base rates would be consistent with this intent. SWEEP also recommends that the DSM adjustor not be specifically identified on the customer bill, as not including the DSM adjustor on the bill would be consistent with the treatment of other energy resources, whose costs are not expressly identified by the current bill format.

   OR

2. If APS plans to make the bill more transparent, SWEEP supports **full** disclosure **on the customer bill** of each and every energy resource, so that no one energy resource is singled out or ghettoized. For example, SWEEP would support the inclusion of a graphic similar to the pie graph presented by APS witness Don Robinson that illustrates how each rate dollar is spent. If such a graphic were included, however, the costs associated with each and every energy resource would need to be clearly delineated.

Infrastructure Tracker

Q. Does SWEEP support the Company-proposed infrastructure tracker (Environmental and Reliability Account or "ERA")?

A. No. SWEEP does not support the ERA and urges the Commission to disapprove the Company-proposed infrastructure tracker. The ERA is too broad and too far reaching. The future costs that the ERA is proposed to address and recover should not be addressed in an infrastructure tracker.

Conclusion

Q. Does this conclude your testimony?

A. Yes.