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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

BOB STUMP, Chairman
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AZ CORP COMMISSION
DOCKET CONTROL

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-12-0291

NOTICE OF FILING DIRECT
TESTIMONY IN SUPPORT OF THE
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 the
Settlement Agreement of Kevin C. Higgins on behalf of AECC in the above captioned
Docket.

RESPECTFULLY SUBMITTED this 15th day of February 2013.

FENNEMORE CRAIG, P.C.

Arizona Corporation Commission

DOCKETED

FEB 15 2013

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2 **FILED** this 15th day of February 2013 with:

3 Docket Control
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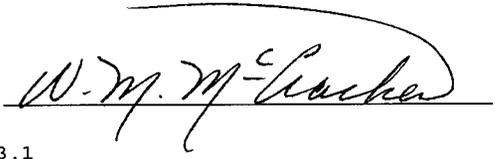
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BEFORE THE ARIZONA CORPORATION COMMISSION

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-12-0291

Direct Testimony of Kevin C. Higgins

on behalf of

Freeport-McMoRan Copper & Gold Inc. and

Arizonans for Electric Choice & Competition

Settlement Agreement

February 15, 2013

DIRECT TESTIMONY OF KEVIN C. HIGGINS

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1 comprehensive resolution of the issues in the Tucson Electric Power (“TEP”)
2 general rate case.

3 **Q. Were you personally involved in the negotiations that resulted in the**
4 **Settlement Agreement?**

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

6 **Q. What is your recommendation to the Commission with respect to the**
7 **Settlement Agreement?**

8 A. I recommend that the Settlement Agreement as submitted by the
9 Signatories be approved by the Commission. In my opinion, the Settlement
10 Agreement produces just and reasonable rates and is in the public interest.

11 **Q. Does AECC support the entire Settlement Agreement?**

12 A. Yes. The Settlement Agreement is a package that was crafted through
13 extensive negotiations among many parties. AECC is recommending adoption of
14 each provision in the Settlement Agreement as a package deal.

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

16 A. First, I offer some summary comments on the overall Settlement
17 Agreement. I follow that with a more detailed discussion of provisions of the
18 Settlement Agreement that are of general importance and certain other provisions
19 that are of particular interest to AECC. I conclude my testimony with a
20 discussion of certain issues raised by Commissioner Pierce in his letter to the
21 parties dated February 1, 2013.

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OVERALL AGREEMENT

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

A. AECC is a customer group. Accordingly, I participated in the Settlement Agreement negotiations from the vantage point of customers in general, with a particular emphasis on the perspective of business customers. In providing a comprehensive resolution of the issues in the TEP general rate case, the Settlement Agreement offers the following benefits to customers:

- It establishes a level of base revenues for TEP that allows the Company a reasonable opportunity to earn a fair return on its investments, while minimizing the rate impact on customers as much as reasonably possible.
- It proposes a reasonable rate of return and capital structure for TEP that equitably balances the interests of shareholders and customers.
- It spreads the overall base rate increase among customer classes in an equitable manner.
- It cures a number of rate design problems in the Company’s filed case, enabling customers to continue to respond to good price signals through well-designed time-of-use (“TOU”) rates.
- It provides for a reasonable amortization period for recovery of energy efficiency investments and an equitable mechanism for cost recovery.
- It provides a narrowly-tailored Lost Fixed Cost Recovery (“LFCR”) mechanism in lieu of full revenue decoupling, while offering an opt-out rate design for residential customers who choose not to participate in the LFCR. For customers

1 with billing demands of 3000 kW or greater, the settlement agreement addresses
2 through rate design TEP's concerns over fixed cost recovery associated with
3 energy efficiency investments.
4

5 **DISCUSSION OF SPECIFIC ISSUES**

6 **Q. In your direct testimony you recommended that TEP's proposed revenue**
7 **requirement for its base rates be reduced by at least \$44.5 million prior to**
8 **taking into account adjustments that may be offered by other parties. Does**
9 **the Settlement Agreement adequately address the revenue requirement**
10 **issues you raised in your direct testimony?**

11 A. Yes. In its filed case, TEP proposed to increase its base rates by \$127.8
12 million. The recommended adjustments in my direct testimony reduced this
13 revenue requirement increase to \$83.2 million. The Settlement Agreement results
14 in a base revenue increase of \$76.2 million. [Section 2.1] However, it also
15 provides for approximately \$5.1 million in sulfur credits and \$12.9 million in lime
16 expense to be moved from base rates to the PPFAC. [Attachment A] After
17 accounting for this reclassification of approximately \$7.8 million (net), the final
18 revenue requirement recommended in the Settlement Agreement is very close to
19 the revenue requirement I had recommended in my direct testimony.²

20 The Settlement Agreement reflects revenue requirement adjustments
21 proposed by Staff, RUCO, and AECC. It incorporates a number of specific
22 adjustments I had recommended in my testimony, as well as variants of other

² Applying the same reclassification to the recommended revenue requirement in my direct testimony produces a revenue requirement increase of \$75.4 million, which is within \$1 million of the \$76.2 million recommended in the Settlement Agreement.

1 adjustments I had recommended. Taken as a whole, the Settlement Agreement
2 adequately addresses the revenue requirement issues I raised in my direct
3 testimony.

4 **Q. Does the Settlement Agreement result in a return on equity and capital**
5 **structure that is reasonable?**

6 A. Yes. In its direct case, TEP proposed a return on equity (“ROE”) of
7 10.75%, which represented an increase of 50 basis points over the 10.25% ROE
8 approved in Decision No. 70628, issued December 12, 2008, in Docket No. E-
9 01933A-07-0402. In my direct testimony, I observed that the 10.25% ROE that
10 TEP was awarded in 2008 exactly matched the median ROE approved for electric
11 utilities in the United States that year. I further observed that in 2011 the median
12 approved ROE had fallen to 10.15%, and for the first three quarters of 2012, it
13 had fallen to 10.05%. Based in part on this information, I incorporated an ROE
14 of 10.1% into AECC’s overall revenue requirement. The Settlement Agreement
15 proposes an ROE for TEP of 10.0% [Section 4.2], which is consistent with these
16 fundamental relationships and lies within the range of reasonableness. The
17 Settlement Agreement also provides for a rate of return of 0.68% on the fair value
18 increment of rate base [Section 4.3], which I believe is reasonable in light of the
19 requirements of the Arizona constitution.

20 In its filing, TEP had proposed the approval of a hypothetical capital
21 structure consisting of 54 percent debt and 46 percent equity. In my direct
22 testimony, I argued that the Company’s proposal unduly increased its revenue
23 requirement; I recommended that the Company’s proposal be rejected in favor of
24 using its actual capital structure which I estimated at the midpoint of 2012. The

1 Settlement Agreement recommends the adoption of TEP's actual capital structure
2 of 55.97% long-term debt, 0.53% short-term debt, and 43.5% common equity,
3 measured at the end of the 2011 test period. [Section 4.1] The use of the
4 Company's actual capital structure in the Settlement Agreement is reasonable and
5 is fair to both TEP and customers.

6 **Q. Does the Settlement Agreement result in a spread of the rate increase across**
7 **customer classes that is fair?**

8 A. Yes. In my direct testimony I proposed an equal percentage base rate
9 increase, inclusive of fuel-related costs, across customer classes, and explained
10 the basis for such an approach. The Settlement Agreement adopts a similar
11 approach by proposing a uniform percentage increase, inclusive of fuel-related
12 costs, for all customer classes except Residential and Small General Service, with
13 the latter two classes receiving a percentage increase that is moderately less than
14 the uniform increase applied to all other classes. In the context of the overall
15 Settlement Agreement, the largely uniform percentage increase, with the modest
16 reduction for Residential and Small General Service, is reasonable.

17 **Q. Attachment B shows an average percentage increase of 13.3 percent for all**
18 **customers. Will the average customer typically experience an overall**
19 **increase of this amount?**

20 A. No. Attachment B shows the average increase in base revenues relative
21 to the test period revenues, inclusive of fuel, which is an appropriate benchmark
22 in a general rate case. However, the Settlement Agreement also proposes that the
23 timing of the base rate increase be coordinated with the next change in the PPFAC
24 Adjustor, which, partly as a result of the settlement terms, would be reduced from

1 a charge of \$0.007696/kWh to a credit of \$0.00138/kWh. [Section 6.1] This large
2 reduction in the PPFAC will offset a substantial portion of the base rate increase
3 for most customers. Consequently, the bill for a residential customer using the
4 annual average of 767 kWh per month will increase by less than \$3.00 per month.
5 [Section 3.1]

6 **Q. In your direct testimony on cost-of-service issues, you objected to the cost-of-**
7 **service methodology used by TEP to allocate production and transmission**
8 **costs to customer classes and you presented two alternative cost-of-service**
9 **studies that employed methodologies used by other utilities in Arizona.**

10 **Does the Settlement Agreement adopt any particular cost-of-service**
11 **methodology?**

12 A. No. The Settlement Agreement makes no references to any party's
13 recommended cost-of-service methodology.

14 **Q. In your direct testimony on cost-of-service issues, you raised a number of**
15 **concerns regarding various TEP rate design proposals. Does the Settlement**
16 **Agreement adequately address those concerns?**

17 A. Yes. In my direct testimony I expressed particular concern about TEP rate
18 design proposals that would have significantly reduced the incentive for
19 customers to shift their energy and demand usage to off-peak periods to take
20 advantage of lower power production costs. This change would have been
21 particularly harmful to businesses that had organized their production schedules to
22 fit the time-of-day parameters in TEP's TOU rate schedules.

23 In negotiating the Settlement Agreement, TEP agreed to withdraw the
24 most problematic structural changes in its filing and worked with AECC and other

1 parties to develop a TOU rate design that maintains the current price signals for
2 LGS and LLP customers to shift power usage off-peak as much as practicable.

3 TEP also agreed to withdraw its proposal for a 100 percent demand ratchet
4 and agreed to the compromise ratchet of 75 percent that I had recommended in
5 my direct testimony.

6 **Q. In your direct testimony on cost-of-service issues, you also raised concerns**
7 **regarding TEP's proposed unbundled rate components. Does the Settlement**
8 **Agreement adequately address those concerns?**

9 A. Yes. In my direct testimony, I questioned the relationship between TEP's
10 proposed delivery charges and the proposed charges to recover fixed generation
11 costs for LLP customers and argued that the proposed unbundled rates were not
12 reflective of the underlying cost relationships between these functions. In
13 negotiating the Settlement Agreement, TEP agreed to redesign the unbundled
14 components in its tariff to align them much more closely with underlying cost
15 relationships. This improvement is incorporated into the unbundled components
16 of the rate schedules filed by TEP in this case.

17 **Q. In your direct testimony on cost-of-service issues, you called for changes in**
18 **TEP's tariff to state that customers taking service at 138 kV or above are not**
19 **subject to the delivery charges stated in the unbundled portion of the tariff.**
20 **Has this issue been addressed in the Settlement Agreement?**

21 A. Yes. The Settlement Agreement provides that in its next general rate case,
22 TEP will propose a rate for customers that take service at 138 kV or higher.
23 [Section 20.6] Although TEP's tariff in this case has not been modified as I had
24 recommended, this provision in the Settlement Agreement will provide a means

1 for this issue to be considered more thoroughly in the next general rate case.
2 AECC agreed to defer consideration of this issue in the spirit of compromise.

3 **Q. In your direct testimony on cost-of-service issues, you recommended**
4 **adoption of the interruptible tariff that TEP filed in Docket No. E-01933A-**
5 **07-0402, subject to certain modifications you proposed. How does the**
6 **Settlement Agreement address this issue?**

7 A. As I discussed in my direct testimony, the settlement agreement approved
8 by the Commission in the last general rate case required TEP to file an
9 interruptible tariff within 90 days of the effective date of the Commission's
10 approval of the agreement. TEP filed a proposed interruptible tariff in 2009 and
11 AECC filed comments and objections requesting a hearing to resolve certain
12 items in dispute. However, no further action has been taken. The Settlement
13 Agreement sets out a schedule to facilitate the resolution of this matter as a
14 compliance item. [Section 20.5]

15 **Q. Please explain your support for adoption of the LFCR in this case.**

16 A. In the past several years, there has been considerable discussion in
17 Arizona on the subject of full revenue decoupling, including the issuance of a
18 policy statement by the Commission in 2010 on the subject. AECC has been
19 steadfastly opposed to full revenue decoupling and considers the narrowly-
20 tailored LFCR approach negotiated in the Settlement Agreement to be vastly
21 superior to implementation of full revenue decoupling. First of all, any recovery
22 of fixed costs through the LFCR mechanism is limited to fixed costs associated
23 with reductions attributable to energy efficiency and distributed generation; lost
24 fixed costs attributable to other factors, such as weather and general economic

1 conditions are excluded. This limitation addresses one of AECC's primary
2 critiques of full revenue decoupling.

3 Secondly, the LFCR is limited to a portion of distribution and transmission
4 costs and excludes costs recovered through the customer charge and 50 percent of
5 the distribution and transmission costs that are recovered through non-generation
6 demand charges; this limitation appropriately recognizes that revenues from such
7 charges are not as sensitive to changes in usage attributable to energy efficiency
8 as are energy charges.

9 Thirdly, the rate impact from the LFCR is capped at 1% per year,
10 mitigating the potential rate impact on customers. [Section 8.4]

11 Fourthly, Residential customers have the ability to opt-out of the LFCR
12 through an alternative rate design. [Section 8.2] This provides greater flexibility
13 to customers.

14 And fifthly, the Settlement Agreement appropriately recognizes that
15 concerns over fixed cost recovery can be adequately addressed for larger
16 customers through rate design, specifically by setting customer charges and
17 demand charges to align properly with TEP's fixed costs. [Section 8.5]

18 Despite these attributes of the LFCR relative to full revenue decoupling,
19 AECC remains concerned about the inclusion of all LGS customers in the LFCR
20 mechanism, as opposed to addressing fixed cost recovery from these customers
21 through rate design. However, in the spirit of compromise, AECC supports the
22 LFCR as designed in this case. AECC will monitor the application of the
23 proposed LFCR going forward.

1 **Q. In your direct testimony on revenue requirements issues, you opposed TEP’s**
2 **proposal for adoption of an Environmental Compliance Adjustor (“ECA”).**
3 **Please explain AECC’s agreement to support adoption of the ECA in the**
4 **Settlement Agreement.**

5 A. The ECA proposed by TEP in its initial filing was open-ended as to its
6 potential rate impacts, whereas the Settlement Agreement caps the ECA surcharge
7 at 0.25 percent of TEP’s total retail revenue. [Section 9.1] This cap provides the
8 ratepayer protection necessary to gain AECC’s acceptance of this provision.

9 **Q. In your direct testimony on revenue requirements issues, you discussed the**
10 **ratemaking treatment of net operating loss (“NOL”) carryforward as it**
11 **applies to TEP’s accumulated deferred income tax (“ADIT”) balance. How**
12 **is this issue addressed in the Settlement Agreement?**

13 A. The Settlement Agreement accepts TEP’s ratemaking treatment of the
14 NOL carryforward for establishing the revenue requirement in this case.
15 However, the Settlement Agreement also provides that within sixty days
16 following the final decision in this docket, TEP will make a filing proposing the
17 Commission open a generic docket to address the appropriate accounting
18 treatment of NOLs in future rate cases. [Section 20.2] This will provide the
19 opportunity to address at a generic level my proposal for establishing a regulatory
20 liability to capture going-forward benefits for customers when utilities are unable
21 to realize fully the cash benefits from accelerated tax depreciation during the test
22 period of a rate case. It will also provide the opportunity to consider other
23 approaches to this issue.

1 **Q. In your direct testimony on revenue requirements issues, you recommended**
2 **that the PPFAC be modified to include a risk-sharing mechanism. You also**
3 **opposed TEP's proposal to include 100 percent of TEP-owned solar**
4 **generation in base rates, including costs above the Market Cost of**
5 **Comparable Conventional Generation. Neither of these positions you**
6 **advocated are included in the Settlement Agreement. Have you changed**
7 **your testimony on these matters?**

8 A. I have not changed my opinion on these topics as isolated matters or when
9 these topics are viewed in the context of TEP's initial application. However, the
10 overall settlement package contains enough benefits to customers that I have
11 concluded that it is in the public interest to move forward with this entire package,
12 including certain items with which I may disagree in isolation. Such is the nature
13 of negotiation and compromise.

14

15 **RESPONSE TO LETTER FROM COMMISSIONER PIERCE**

16 **Q. Have you reviewed the letter to the parties filed in this docket by**
17 **Commissioner Gary Pierce on February 1, 2013?**

18 A. Yes, I have. Commissioner Pierce notes that the Preliminary Settlement
19 Term Sheet filed in this docket indicated that TEP would implement an Energy
20 Efficiency ("EE") Resource Plan that is intended to treat energy efficiency and
21 demand-side management in a manner similar to a generation resource. Pursuant
22 to the plan, TEP would invest in cost-effective energy efficiency programs that
23 have been approved by the Commission and earn the rate of return established in

1 this case on that investment. The investment costs and the return on the
2 investment would be recovered through an after-the-fact DSM surcharge.

3 Commissioner Pierce's letter offers a number of comments that raise
4 several questions concerning this proposal, which in the Settlement Agreement is
5 contained in Section VII.

6 In particular, Commissioner Pierce questions the relationship between an
7 EE model, on the one hand, that provides for a return on TEP's EE investment,
8 and the presumed need, on the other hand, for Commission mandates for TEP to
9 invest in cost-effective EE programs. Specifically, Commissioner Pierce states
10 that he "would expect parties who advocate for the adoption of a settlement
11 agreement that would allow TEP to rate base its energy efficiency and demand-
12 side management costs, to simultaneously advocate for TEP to be permanently
13 exempted from the Commission's energy efficiency rules."

14 **Q. Do you wish to respond to Commissioner Pierce's statement?**

15 A. Yes. I think that Commissioner Pierce's point is well taken. AECC has
16 consistently advocated that the funding levels for utility-sponsored EE
17 investments should consider not only the projected cost-effectiveness of the EE
18 programs, but also the current-day rate impact of funding them. For example,
19 AECC recently included the following statement in its comments to the Salt River
20 Project Board as part of SRP's 2012 Pricing Process:

21 In its 2012 Pricing Plan proposal, SRP indicates that funding for EE and
22 Renewable Energy programs is being increased and accelerated in response to
23 customer and stakeholder feedback during a public process conducted during the
24 spring of 2011. However, AECC participated in that process and offered a very
25 different message: AECC urged caution, sensitivity to price impacts, and an
26 emphasis on cost-effectiveness over strict adherence to predetermined

1 sustainability targets. AECC specifically recommended that any rate increase to
2 meet the sustainability program goals should be limited to a 0.25% impact on
3 rates in a given year.

4 The Settlement Agreement calls for adoption of an EE Resource Plan as
5 proposed by Staff. AECC supports this provision in the Settlement Agreement as
6 part of the overall package. At the same time, it is my understanding that the
7 Settlement Agreement is not intended to hinder any efforts the Commission may
8 wish to undertake to revise its EE policies. So, for example, adoption of the
9 Settlement Agreement by the Commission and, with it, adoption of Staff's
10 recommended EE Resource Plan for the coming year, should not preclude the
11 Commission from exempting TEP from the EE Rules going forward, if the
12 Commission determines that such an exemption is appropriate. Alternatively, the
13 Commission could consider amending the EE Rules to address the situation of an
14 electric utility that recovers its EE funding using a return on investment approach.

15 **Q. Are there other issues raised in Commissioner Pierce's letter to which you**
16 **wish to respond?**

17 A. Yes. A related question in Commissioner Pierce's letter concerns the
18 appropriateness of charging customers for EE costs through a separate DSM
19 surcharge if EE costs are being treated as a rate base item. Commissioner Pierce
20 notes that he is not necessarily opposed to a separate surcharge.

21 In response, I recommend that the Commission retain a separate DSM
22 surcharge even if EE costs are booked as a regulatory asset and treated
23 comparably to a component of rate base. I believe it still makes sense to
24 separately state these costs and make them known to the public.

1 **Q. If energy efficiency is treated like a resource, why should recovery of EE**
2 **program costs occur through a separate charge on customers' bills?**

3 A. Energy efficiency may be a resource, but its character is fundamentally
4 different from other resources. Unlike supply-side resources, the entirety of the
5 "output" from energy efficiency – and the overwhelming share of the benefits
6 from it – accrue directly to the program participant(s). Under the current and
7 proposed EE plan, TEP's investments in energy efficiency do not actually
8 "belong" to TEP nor are they held by TEP on behalf of customers as a whole, but
9 rather are the private property of the program participants who tapped into the
10 pool of EE funding to undertake their projects. Because the "output" and
11 benefits from utility energy efficiency programs are so strongly segmented based
12 on participation and non-participation, it is important as a matter of transparency,
13 for the costs of EE programs to be separately stated on customers' bills so that
14 customers can be aware of the cost. Awareness of the charge might also prompt
15 more customers to participate in the programs.

16 **Q. Does this conclude your settlement testimony?**

17 A. Yes, it does.