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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

- BOB STUMP, Chairman
- GARY PIERCE
- BRENDA BURNS
- BOB BURNS
- SUSAN BITTER SMITH

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

ARIZONA INVESTMENT COUNCIL'S POST-HEARING BRIEF

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The Arizona Investment Council ("AIC") submits this Post-Hearing Brief in support of the Updated Settlement Agreement ("Settlement Agreement") filed in this docket on March 1, 2013.¹ The AIC—its corporate and its some 6,000 individual members—joins 17 other parties ranging from the Utilities Division Staff through the Residential Utility Consumer Office, large industrial consumers and low-income advocates to the IBEW, the Department of Defense and Tucson Electric Power Company (the "Company" or "TEP) in urging approval of the Settlement Agreement.

Introduction

TEP's current rates are premised on costs and expenses in a test year which closed December 31, 2006. In the intervening more than six years, growth in the Company's service area "has come to a virtual standstill and customer usage has declined since the prior rate case.

¹ The AIC also joins in Tucson Electric Power Company's Initial Post-Hearing Brief (the "TEP Brief").

1 As a result, TEP's retail kWh sales have remained essentially flat on a year-to-year basis since
2 2006.²

3 However, while 2008's economic collapse clearly flattened customer usage, what the
4 Great Recession did not chill was (1) TEP's need to make substantial capital improvements to its
5 plant to maintain safe and reliable service, as well as (2) the Company's corresponding need to
6 increase operating and maintenance expenses to assure those service requirements were met. As
7 a result, since its last rate case, while sales have been stagnating, TEP's original cost rate base
8 has increased 50% or \$500 million to \$1.5 billion and O&M costs have gone up about
9 \$29 million over the test year levels current rates are premised on.³

10 TEP President David Hutchens summarized the Company's cost containment success as
11 follows:

12 TEP has faced rising prices for materials, equipment and fuel; higher
13 labor, pension and medical costs; and increased compliance expenses associated
14 with new environmental and cyber security regulations. Despite these pressures,
15 we have constrained the growth of TEP's operating and maintenance
16 expenses...to an average of 1.6 percent per year through prudent management of
17 our operations.⁴

18 Given (1) declining to flat sales, (2) cost increases in all operational quadrants plus
19 (3) the passage of so many years since rates were last adjusted, the fact that this Settlement
20 Agreement holds the average residential bill impact to under \$3.00 a month definitely qualifies it
21 as remarkably consumer friendly. But, its terms have also drawn favorable comments from
22 credit rating agencies. As Mr. Hutchens points out,⁵ the day after the initial Settlement

22 ² Application, p. 2, TEP-7.

23 ³ *Id.*

23 ⁴ Hutchens Direct in Support of Settlement Agreement, p. 2, TEP-2.

24 ⁵ *Id.*, p. 7.

1 Agreement was filed, Moody's published a report stating it views the Settlement Agreement as
2 credit positive:

3 TEP's positive outlook reflects the...anticipated credit supportive outcome
4 in TEP's upcoming rate case, the expectation of continued stable cash flows,
5 reasonably timely recoveries of fuel and purchased power costs and credit metrics
6 remaining strong.

7 TEP consumers—large and small—will benefit from this positive outlook assuming
8 approval of the Settlement Agreement. Among other investment needs, the Company faces
9 significant, costly environmental compliance demands on its internal capital and the capital it
10 must raise from debt and equity markets. Positive outlooks, good credit ratings, reasonable
11 earnings and timely cost recoveries allow the Company to secure that required capital at the
12 lowest reasonable cost.

13 Given these and other factors, AIC President and CEO Gary Yaquinto states AIC's
14 recommendation as follows:

15 The Settlement Agreement represents an appropriate, productive balance
16 among the often widely divergent views of the parties on a broad and challenging
17 set of issues...It builds on progress from the last rate case and should give the
18 Company a realistic opportunity to recover its prudent costs and to earn a
19 reasonable rate of return on investment. We recommend the Commission enter its
20 Order approving the Settlement Agreement.⁶

21 Because recovering costs and earning a reasonable return are increasingly more difficult
22 in the face of (1) ever more costly environmental compliance obligations and (2) eroding fixed
23 cost recovery resulting from increased energy efficiency and distributed generation deployment
24 on the Company's system, the AIC will focus the balance of this brief on the two settlement

⁶ AIC-2, p. 4.

1 provisions specifically aimed at those challenges: the Environmental Compliance Adjustor and
2 the Lost Fixed Cost Recovery mechanism.

3 The Environmental Compliance Adjustor (“ECA”)

4 Environmental cost adjustors such as the ECA are growing increasingly more common in
5 Arizona and across the Nation. Here, the Commission approved an Environmental Improvement
6 Surcharge or EIS for Arizona Public Service Company (“APS”) several years ago (Decision
7 No. 69663) and in last year’s rate case (Decision No. 73183) approved a mechanism for APS
8 very similar to the ECA recommended by the parties to this case for TEP.

9 Nationally, Mr. Yaquinto noted that: “[E]nvironmental adjustment clauses or rate riders
10 have been authorized in 27 states...for over 60 utility companies to more timely deal with the
11 costs of government-mandated environmental controls.”⁷ Consistent with that, this ECA will
12 allow TEP more timely to recover a portion of the total costs of its government-mandated capital
13 outlays—outlays which are expected to approach another \$400 million in new capital
14 requirements over the next several years.⁸

15 A detailed ECA plan of administration is attached to the updated Settlement Agreement
16 as Attachment G. Briefly to summarize, the Company is allowed to earn a return on installed,
17 government-mandated environmental investments plus associated depreciation, taxes and tax
18 credits, where appropriate, together with the O&M costs associated with operating the
19 environmental facilities.

20 From a consumer’s standpoint, ECA cost recovery is capped at .25% (one quarter of one
21 percent) of the total TEP retail revenue requirement approved by the Commission in this case, so
22

23 ⁷ AIC-1, pp. 5-6.

24 ⁸ TEP-7, Application, p. 10.

1 rate adjustments will be small. Further, the more timely recovery of at least some of these
2 mandated costs between rate cases will help smooth future consumer rate increase impacts.⁹

3 The Lost Fixed Cost Recovery Mechanism (“LFCR”)

4 Another important Settlement Agreement “clause” is the LFCR. The mechanism is very
5 similar to the LFCR approved by the Commission for APS last year.¹⁰ It will help stabilize
6 earnings in the face of unrecovered fixed costs caused by reduced sales attributable to energy
7 efficiency and distributed generation efforts.

8 A detailed LFCR plan of administration is Attachment F to the Settlement Agreement.
9 Its key elements include: recovery of a portion of the distribution and transmission costs
10 associated with lower sales levels resulting from EE and DG programs; no recovery of lost fixed
11 costs resulting from the impacts of weather or general economic conditions; and a 1% year-over-
12 year cap limitation.

13 During the hearing, the Administrative Law Judge requested party comment on what
14 procedural mechanism should be used in the future should any problems develop with cost
15 recovery through the ECA or the LFCR. As an initial matter, AIC does not believe it likely that
16 any problems will arise. Detailed plans of administration have been formulated, filed and
17 reviewed by all parties for both clauses. Further, and as discussed, an ECA-like mechanism has
18 been in effect for APS for several years without administrative or cost recovery problems arising.

19 As for the LFCR, in 2010 the Commission conducted an extensive review of the need for,
20 and appropriate mechanics of, such clauses. That culminated in issuance of the ACC Policy
21 Statement Regarding Utility Disincentives to Energy Efficiency and Decoupled Rate Structures.

22 ⁹ AIC 2, p. 3.

23 ¹⁰ In late 2011, the Commission also approved a decoupler mechanism for Southwest Gas in Decision No. 72723.
24 Although it is significantly different than the LFCR, the decoupler is also an adjustor clause which is aimed at
addressing lost fixed cost recovery issues.

1 Both the Commission-approved Southwest Gas decoupler and the LFCR mechanism in place for
2 APS have been functioning without any administrative, recovery or other problems.

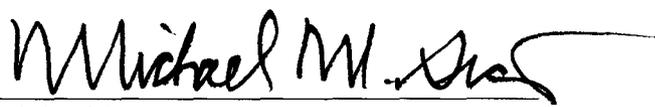
3 However, in the unlikely event that a problem should develop with either clause, AIC
4 agrees with the conclusion stated in the TEP Brief, i.e., that any necessary adjustments should be
5 pursued through the A.R.S. § 40-252 procedure and requirements. That process, among other
6 things, would place all parties, including TEP, on notice that the Commission believes its Order
7 should be re-opened and re-visited as to either or both procedures.

8 **Conclusion**

9 The AIC urges the Administrative Law Judge to recommend approval of, and the
10 Commission to approve, the Settlement Agreement. Its terms are broadly supported, fair,
11 balanced and in the public interest.

12 RESPECTFULLY SUBMITTED this 22nd day of March, 2013.

13 GALLAGHER & KENNEDY, P.A.

14
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