ORIGINAL

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 ARIZONA ELECTRIC POWER COOPERATIVE, INC. FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RETURN THEREON AND TO APPROVE RATES DESIGNED TO DEVELOP SUCH RETURN.	DOCKET NO. E-01773A-12-0305 **STAFF'S CLOSING BRIEF**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby submits its closing brief in the above-referenced matter.

I. INTRODUCTION.

Arizona Electric Power Cooperative, Inc. ("AEPCO") is a customer-owned generation cooperative that serves all or a portion of the wholesale power needs of its three all-requirements ("ARM") and three partial-requirements ("PRM") Class A Member distribution cooperative customers.[1] AEPCO's three Class A PRM's are Trico Electric Cooperative, Inc. ("Trico"), Mohave Electric Cooperative, Inc. ("Mohave"), and Sulphur Springs Valley Electric Cooperative, Inc. ("Sulphur Springs").[2] AEPCO's three Class A ARM's are Anza Electric Cooperative, Inc., Duncan Valley Electric Cooperative, Inc., and Graham County Electric Cooperative, Inc.[3] AEPCO is managed and governed by its board of directors, all of whom are representatives of its cooperative customers.[4]

On July 5, 2012, AEPCO filed an application for a decrease in its rates. In its application, APECO requested a revenue decrease of approximately $4.527 million or approximately 2.92% decrease over its current revenues using a pro forma adjusted test year ending December 31, 2011.[5]

[1] Exh. AEPCO-1 (Direct Testimony of Peter Scott) at 2.
[2] *Id.* at 2. Trico, Mohave, and Sulphur Springs are also parties to this rate case proceeding.
[3] *Id.*
[4] *Id.* at 3-4.
[5] Exh. AEPCO-6 (Rejoinder Testimony of Gary E. Pierson) at Exh. GEP-9.

Shortly before the filing of Staff's Direct Testimony, AEPCO informed Staff of pending regulatory rule changes at the Environmental Protection Agency ("EPA") that would impact the costs of operating AEPCO's Apache Generating Station ("Apache Station").[6] The rules, known as the Regional Haze Rules, would require limitations on emissions through the implementation of plant infrastructure improvements. AEPCO informed Staff that under two alternative proposals to meet the Regional Haze Rules, that its estimated costs would be between $30 and $190 million depending on which alternative EPA determines is acceptable.[7]

AEPCO subsequently modified its request to reflect a revenue decrease of approximately $4.287 million or approximately a 2.77 percent decrease over its current revenues using a pro forma adjusted test year ending December 31, 2011.[8] The requested revenue decrease results in a Debt Service Coverage ("DSC") ratio of 1.32.[9] Additionally, the AEPCO proposal reduces net margins from $6.244 million to $1.957 million, a nearly 70 percent decrease in its margin.[10]

In light of the need to fund possible EPA compliance requirements, AEPCO is also requesting the approval of a new rate adjustor mechanism, referred to by AEPCO as the Environmental Compliance Adjustment Rider ("ECAR").[11] Although specifics have yet to be provided, in general terms the ECAR would allow AEPCO to recover such investments as may prove necessary to comply with the EPA mandated Regional Haze requirements at Apache Station.[12] AEPCO is requesting that the ECAR be approved only if the Commission grants AEPCO's requested revenue decrease.[13] In that event, AEPCO recommends leaving this docket open to develop the process for, and details of, the ECAR mechanism.[14]

Staff is recommending no change be made to AEPCO's revenue requirement at this time which will have the effect of keeping rates at their current levels.[15] Staff's recommendation results in

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[6] *See* Exh. S-10 (Confidential Data Response RV 5.9) analyzing two scenarios of potential capital expenditures for EPA compliance.
[7] *Id.*
[8] Exh. AEPCO-6 at Exh. GEP-9.
[9] *Id.*
[10] Tr. Vol I at 70:20 – 71:9; Exh AEPCO-6 at Exh. GEP-9.
[11] Exh. AEPCO-6 at 7-8.
[12] *Id.*
[13] Exh. AEPCO-6 at 7.
[14] *Id.*
[15] Exh. S-4 (Direct Testimony of Randall E. Vickroy) at 18-19.

a DSC ratio of 1.55 which provides net margins of $6,244,686.[16] Staff opposes AEPCO's requested rate decrease, but does not oppose leaving this docket open to develop the process for, and details of, the ECAR mechanism.[17]

II. NOW IS <u>NOT</u> THE TIME FOR A RATE DECREASE.

AEPCO is requesting the same DSC ratio that was approved by the Commission in its last rate case.[18] However, AEPCO currently faces significant challenges and risks that were not present in its last rate case.[19] First, it is certain that AEPCO will need to expend a substantial amount of money in the near future as a result of the pending EPA regulations affecting Apache Station.[20] Second, even without the EPA regulations, the economic viability of Apache Station is in serious doubt.[21] For these reasons, Staff opposes the requested rate decrease and recommends that rates be kept at their present levels.

A. A Rate Decrease Today Is Inappropriate Because the EPA Regulations Will Require A Rate Increase Above and Beyond Current Rates.

"...what we are seeing here, short-term gain at the expense potentially of long-term pain."

-Staff Witness John Antonuk[22]

There is no dispute that AEPCO will need to expend a substantial amount of money in order to comply with the pending EPA regulations at Apache Station. The only uncertainty is how substantial these costs will be. If the EPA accepts AEPCO's alternative proposal to invest $30 million in environmental improvements to Apache Station, rates are estimated to go up by a percentage greater than AEPCO's requested decrease.[23] On the other hand, if AEPCO is required to spend $190 million in environmental improvements to Apache Station (as the EPA rules currently contemplate), rates are estimated to go up by a percentage almost four times higher than if the EPA

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[16] Exh AEPCO-6 at Exh. GEP-9.
[17] Exh. S-3 (Surrebuttal Testimony of Dennis M. Kalbarczyk) at 6.
[18] Tr. Vol. II at 194:5-8.
[19] *Id.* at 194:9-12.
[20] *Id.* at 194:13-22.
[21] *Id.* at 246:15-247:7; Tr. Vol. II at 194:23-195:19.
[22] Tr. Vol. II at 255:2-3.
[23] *See* Exh. S-10 (Confidential Data Response RV 5.9) analyzing the rate impact of the two scenarios of potential capital expenditures for EPA compliance.

approves AEPCO's alternative proposal.[24] Clearly, under either scenario, AEPCO will need to increase its rates above what they are today.[25] As a result, it would be inappropriate to briefly reduce rates now only to raise them to account for these costs and by a degree greater than the decrease.

AEPCO's proposed ECAR does not mitigate the troubling effect of AEPCO's requested rate decrease, namely rate shock to customers.[26] If the ECAR is adopted by the Commission, it will likely be designed to capture the substantial costs associated with the EPA upgrades and pass those costs along to the customers.[27] Stated another way, the effect of AEPCO's requested rate decrease will be negated and replaced by the much higher costs that would be passed on to customers.[28] As a result, the ECAR does not alleviate the risk of rate shock to customers.

AEPCO's proposed rate decrease is also inappropriate because it is not sustainable.[29] As Mr. Antonuk testified, "that's very troubling[] [because] [t]he amount that's at stake with the $30 million proposal says that rates will very shortly be north of what they are today."[30] If AEPCO's $30 million proposal is accepted by the EPA, AEPCO's requested DSC ratio of 1.32 will be insufficient to meet the lower end of the potential capital financing obligations necessitated to comply with EPA.[31] However, AEPCO has agreed that an extraordinary mechanism like the ECAR is inapplicable in the event that the Commission approves a DSC of 1.55 and the associated revenue requirement.[32]

B. A Rate Decrease Is Not Appropriate When the Viability of AEPCO's Only Generating Plant Is In Jeopardy.

Staff believes the uncertain economic viability of Apache Station puts AEPCO at risk. Since AEPCO's last rate case, energy markets have changed as the price of natural gas has decreased over time.[33] As a result, Apache Station has been less able to compete with less expensive combined cycle

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[24] *Id.*
[25] Tr. Vol. II at 250:18-25.
[26] *Id.* at 227:23-228:6
[27] Staff notes that the details of how the ECAR will operate have not yet been discussed by the parties. For example, it is unclear whether AEPCO intends for this adjustor mechanism to capture non-capital expenditures such as O&M costs.
[28] Tr. Vol. II at 251:15-23.
[29] *Id.* at 251:5-11.
[30] *Id.* at 251:8-11.
[31] *Id.* at 232:21-233:22.
[32] Tr. Vol. I at 75:21-24.
[33] Tr. Vol. II at 194:23-195:3.

gas generation.[34] This inability to compete is evidenced by the fact that Apache Station did not run its units in 2011 and 2012 nearly as much as it had in previous years.[35] In addition, the EPA has made it clear that it will continue to be tough on coal-fired units around the country.[36] In light of these risks, AEPCO has agreed to engage in a study ("Apache Station Study") to determine whether it is prudent to make further investments in Apache Station [37]

As described by AEPCO's witness Mr. Richard Kurtz, the purpose of the Apache Station Study is twofold: 1) to confirm that spending $30 million and increased operating costs related to environmental upgrades at Apache Station as a result of the EPA's regulations is the best possible course of action for AEPCO;[38] and 2) to explore all other alternatives to that proposal, including replacing the coal units with some other resource given current market pricing and fuel cost projections[39] as illustrated by the following response given by Mr. Kurtz during the evidentiary hearing.

> Q. And if those alternatives turn out to be better, I assume that AEPCO would pursue the alternatives, is that correct?
>
> A. If the alternatives turn out to be better, then **we have a big decision to make**. That is **a huge**, that is a **huge decision**.[40]

Indeed, AEPCO will have a weighty decision to make when the Apache Station Study is completed in June of 2014 – *just seven months* after AEPCO is requesting its proposed rate decrease to take effect. Given the potential magnitude of the Apache Station Study findings, including the potential costs associated with pursuing an alternative to the estimated $30-$190 million EPA capital expenditures, AEPCO's requested rate decrease is inappropriate at this time.

III. CONCLUSION.

Customers deserve rate stability and rate predictability.[41] Decreasing rates temporarily, only to increase them to much higher levels in the near future sends the wrong message to customers, and

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[34] *Id.* at 195:4-10.
[35] *Id.* at 195:4-10.
[36] *Id.* at 196:4-6.
[37] *See* Exh. AEPCO-7.
[38] Tr. Vol. I at 46:12-15.
[39] *Id.* at 46:16-47:9.
[40] *Id.* at 47:11-16.

is contrary to the Commission's goal of promoting rate gradualism.[42] AEPCO's requested rate decrease would not only soon disappear, but it would be replaced by an even larger rate increase.[43] Under the best possible scenario, AEPCO will only be required by the EPA to expend $30 million at Apache Station. This would mean that if AEPCO's requested 2.77 percent *decrease* is granted, AEPCO would need to turn around and *increase* its rates over and above the amount of the decrease. Moreover, AEPCO's DSC ratio of 1.32 would not allow AEPCO to pay for the capital and expense cost increases caused by a $30 million EPA mandated capital expenditure. Therefore, even under the best case scenario, AEPCO's requested rate decrease is unwarranted.

Staff's recommendation to leave rates at their present levels better serves the principles of rate stability, rate predictability, and rate gradualism. Staff's recommendation will better prepare AEPCO to weather the regulatory and business risks confronting it, including the high risk of rate shock for customers. Staff's recommendation also better prepares AEPCO to face the substantial costs that will be imposed by the EPA. Specifically, Staff's recommended 1.55 DSC ratio would allow AEPCO to pay for the capital costs associated with a $30 million EPA expenditure (assuming the EPA accepts AEPCO's alternative proposal) without the need for an additional rate increase or the need for the ECAR. For these reasons, Staff respectfully urges the Commission to adopt its recommendation.

RESPECTFULLY SUBMITTED this 30th day of August, 2013.

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[41] Tr. Vol. II at 251:24-252:10.
[42] *See* Exh. S-10 (Confidential Data Response RV 5.9).
[43] Tr. Vol. II at 250:18-251:1.

Original and thirteen (13) copies
of the foregoing were filed this
30th day of August, 2013 with:

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