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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 REPLY BRIEF**

The Utilities Division ("Staff") of the Arizona Corporation Commission ("Commission") hereby responds to the initial closing briefs of Arizona Electric Power Cooperative, Inc. ("AEPCO"), Trico Electric Cooperative, Inc. ("Trico"), and Mohave Electric Cooperative, Inc. ("Mohave") submitted in the above-referenced matter.[1] The remaining issue in this matter is whether AEPCO's rates should temporarily decrease in the short-term knowing that rates will ultimately increase higher than they are today in the long-term.

I. RATES WILL INCREASE HIGHER THAN THEY ARE TODAY AS A RESULT OF RECENT EPA REGULATION.

To comply with the Environmental Protection Agency's ("EPA") Regional Haze Rules impacting Apache Generating Station ("Apache Station"), AEPCO has estimated that its costs would be between \$30 and \$190 million depending on which alternative the EPA determines is acceptable. Although the EPA has not yet approved any proposal, AEPCO, Trico, and Mohave optimistically represent that the EPA will accept AEPCO's alternative plan to expend \$30 million. However, even under this best case scenario, AEPCO has estimated that it will need to increase rates higher than they presently exist.[2] On the other hand, if the EPA rejects the \$30 million alternative, AEPCO estimates that rates will need to increase by a far greater number. Clearly, under either scenario, AEPCO will need to increase its rates above what they are today.[3] As a result, AEPCO's requested rate decrease

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[1] Staff incorporates by reference the arguments contained in its initial Closing Brief.

[2] *See* Exh. S-10 (Confidential Data Response RV 5.9) analyzing the rate impact associated with the two scenarios of potential capital expenditures for EPA compliance.

[3] Tr. Vol. II at 250:18-25.

is inappropriate because it runs contrary to the principles of rate stability, rate predictability, and rate gradualism.

AEPCO nonetheless contends that Staff's recommendation to keep rates at their present level is flawed because it is "based on the chance those millions might be needed."[4] However, AEPCO's argument is misleading. With respect to the EPA regulations affecting Apache Station, there is no question that millions of dollars will be needed. The only question is how many millions of dollars will be needed. At best, AEPCO will only need to spend $30 million in capital expenditures which would negate AEPCO's requested rate decrease with an even higher rate increase.[5] In light of this realization, 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.

II. STAFF'S RECOMMENDATION TO KEEP RATES AT THEIR CURRENT LEVEL IS THE MOST APPROPRIATE COURSE OF ACTION.

A. Staff's Recommended DSC Ratio Better Prepares AEPCO To Face the Risks and Uncertainties.

AEPCO contends that Staff's recommended DSC ratio of 1.55 is the result of flawed methodology.[6] Specifically, AEPCO asserts that Staff "arbitrarily backed into a DSC 'fallout' number" of 1.55.[7] However, AEPCO misconstrues the nature of Staff's recommendation.

Staff's recommendation in this matter is to leave rates at their present level given the specific risks and uncertainties facing AEPCO, namely the pending EPA regulations and the decline in the cost competitiveness of Apache Station. In this regard, Staff does not believe it is appropriate to temporarily decrease rates now knowing that rates will soon need to increase to a higher level than they are today. Staff's recommendation to leave rates the same results in a DSC ratio of 1.55 which serves to confirm the reasonableness of that recommendation.

AEPCO agrees that the normal DSC range for Generation and Transmission ("G&T") cooperatives is between 1.20 and 1.50.[8] However, the significant risks and uncertainties facing

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[4] AEPCO Brief at 8:12-13 (emphasis in original).
[5] Exh. S-10 (Confidential Data Response RV 5.9).
[6] AEPCO Brief at 9.
[7] *Id.*

AEPCO are not normal; therefore, a higher DSC ratio is warranted in this case. Staff's recommended DSC ratio of 1.55 (only 5 basis points above the normal range) appropriately and reasonably recognizes the increased risks and uncertainties that are presently confronting AEPCO.

B. Rates Should Not Decrease Even If the EPA Accepts AEPCO's $30 Million Proposal.

AEPCO criticizes Staff for not changing its recommendation to leave rates at their present levels after learning of the possibility that the EPA might accept AEPCO's proposal to spend $30 million in capital expenditures at Apache Station.[9] However, AEPCO's criticism is misguided for several reasons.

First, the possibility that the EPA might accept AEPCO's $30 million proposal does not eliminate the possibility that the EPA may reject that proposal and require the original $190 million mandate. Second, if the EPA accepts the $30 million proposal, Staff's recommendation will allow AEPCO to maintain a healthy DSC ratio without the need for a rate increase or an ECAR mechanism. Conversely, AEPCO's requested DSC ratio of 1.32 will be insufficient for AEPCO to incur $30 million in debt. Accordingly, Staff's recommendation to keep rates at their present level remains the most appropriate course of action for AEPCO in the event that the EPA accepts the $30 million proposal. Indeed, the fact that AEPCO failed to consider changing its request for a rate decrease after learning that the EPA will require AEPCO to spend between $30 million and $190 million in capital expenditures at Apache Station makes this criticism seem all the more misplaced.[10]

C. The ECAR Does Not Alleviate the Concern of Rate Shock To Customers.

AEPCO maintains that its requested Environmental Compliance Adjustment Rider ("ECAR") is an appropriate way for AEPCO to address cost recovery associated with EPA compliance.[11] However, AEPCO fails to recognize that these are costs that will be passed on to the customers. If the Commission approves the ECAR mechanism, the effect of AEPCO's requested rate decrease will be negated by and replaced by the much higher costs that would be passed on to customers through

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[8] Exh. A-5 (Pierson Rebuttal Testimony) at 1:16-17.
[9] AEPCO Brief at 11.
[10] Tr. Vol. I at 29:8-11.
[11] AEPCO Brief at 7.

the implementation of the ECAR.[12] Accordingly, the ECAR would do nothing to mitigate the troubling effect of AEPCO's requested rate decrease, namely potential rate shock to customers.

D. AEPCO Is Facing Risks And Uncertainties That Were Not Present During AEPCO's Last Rate Case.

Trico urges the Commission to adopt the same DSC ratio (1.32) that it approved in AEPCO's last rate case (Decision No. 72055, January 6, 2011). In support, Trico argues that many of the factors affecting AEPCO have remained unchanged or improved since the last rate case.[13] However, Trico's position fails to fully appreciate the significant factors that were not in existence at the time of AEPCO's last rate case.

Specifically, it is undisputed that the pending EPA regulations (which may require AEPCO to incur capital costs ranging from $30 million to $190 million) were not in existence at the time the Commission approved AEPCO's last rate case. As discussed above, AEPCO has estimated that these costs will cause rates to increase beyond what they are today. In addition, the competitiveness of Apache Station has markedly declined since the last rate case as 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.[14] This is not surprising since the price of natural gas has decreased over time.[15] As a result, the continued viability of Apache Station is at risk because it has experienced decreasing competitiveness relative to less expensive combined cycle gas generation.[16] Given these new risks and uncertainties, Staff's recommendation to leave rates at their present level (which results in a DSC ratio of 1.55) is the most appropriate course of action for AEPCO.

III. CONCLUSION.

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

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[12] Tr. Vol. II at 251:15-23.
[13] Trico Brief at 6-9.
[14] *Id.* at 195:4-10.
[15] Tr. Vol. II at 194:23-195:3.
[16] *Id.* at 195:4-10.

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 the foregoing reasons, Staff respectfully urges the Commission to adopt its recommendation.

RESPECTFULLY SUBMITTED this 12th day of September, 2013.

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