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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF UNS ELECTRIC, INC. FOR AN ACCOUNTING ORDER IN CONNECTION WITH THE ACQUISITION OF UP TO A 25% INTEREST IN GILA RIVER POWER PLANT UNIT 3.	DOCKET NO. E-04204A-13-0476

ORIGINAL

NOTICE OF FILING

The Residential Utility Consumer Office ("RUCO") hereby provides notice of filing the Direct Testimony of Jeffrey M. Michlik, in the above-referenced matter.

RESPECTFULLY SUBMITTED this 5th[th] day of December, 2014.

Daniel W. Pozefsky
Chief Counsel

AN ORIGINAL AND THIRTEEN COPIES
of the foregoing filed this 5th day
of December, 2014 with:

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UNS ELECTRIC, INC.

DOCKET NO. E-04204A-13-0476

DIRECT TESTIMONY

OF

JEFFREY M. MICHLIK

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

DECEMBER 5, 2014

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EXECUTIVE SUMMARY

On December 31, 2013, UNS Electric, Inc. ("UNS or Company") filed an application with the Arizona Corporation Commission ("Commission") requesting an accounting order authorizing the deferral for future recovery of non-fuel costs associated with the Company's prospective purchase of up to a 25 percent interest in Unit 3 at the Gila River Power Plant ("Gila Unit 3"). These costs would include depreciation and amortization costs, property taxes, O&M expenses and carrying costs associated with owning, operating and maintaining the Plant.

Since that time Staff and UNS have agreed to changes in UNS' accounting order.

The direct testimony of Jeffrey M. Michlik addresses UNS' request for an accounting order.

RUCO recommends the revised accounting order, as agreed to by UNS and Staff be approved, subject to the addition of the following recommended language:

IT IS FURTHER ORDERED that in the event a settlement agreement is reached in UNS Electric, Inc.'s next rate case, any changes to the deferral order including changes to the carrying costs shall be thoroughly explained in the settlement agreement.

I. INTRODUCTION

Q. Please state your name, occupation, and business address.

A. My name is Jeffrey M. Michlik. I am a Public Utilities Analyst V employed by the Arizona Residential Utility Consumer Office ("RUCO"). My business address is 1110 West Washington Street, Suite 220, Phoenix, Arizona 85007.

Q. Briefly describe your responsibilities as a Public Utilities Analyst V.

A. In my capacity as a Public Utilities Analyst V, I analyze and examine accounting, financial, statistical and other information and prepare reports based on my analyses that present RUCO's recommendations to the Arizona Corporation Commission ("Commission") on utility revenue requirements, rate design and other matters. I also provide expert testimony on these same issues.

Q. Please describe your educational background and professional experience.

A. In 2000, I graduated from Idaho State University, receiving a Bachelor of Business Administration Degree in Accounting and Finance, and I am a Certified Public Accountant with the Arizona State Board of Accountancy. I have attended the National Association of Regulatory Utility Commissioners' ("NARUC") Utility Rate School, which presents for study and review general regulatory and business issues. I have also attended various other NARUC sponsored events.

I joined RUCO as a Public Utilities Analyst V in September of 2013. Prior to my employment with RUCO, I worked for the Arizona Corporation Commission in the Utilities Division as a Public Utilities Analyst for a little over seven years. Prior to employment with the Commission, I worked one year in public accounting as a Senior Auditor, and four years for the Arizona Office of the Auditor General as a Staff Auditor.

Q. What is the scope of your testimony in this case?

A. I am presenting RUCO's analysis and recommendations on UNS' proposed accounting to defer for future recovery of specific non-fuel costs related to its planned 25 percent acquisition/ownership stake in Unit 3 at the Gila River Power Plant ("Gila Unit 3"), including: (i) depreciation and amortization costs, (ii) property taxes, (iii) O&M expenses, (iv) a carrying cost on the Plant investment ("carrying costs"), and (v) any other non-fuel Plant costs.

II. UNS CORPORATE STRUCTURE

Q. Can you provide some more background on UNS' corporate structure?

A. Yes. UNS Energy is a subsidiary of Fortis Inc., the largest investor-owned electric and gas distribution utility in Canada. UNS Energy is based in

Tucson, Arizona and is the parent company of both Tucson Electric Power (TEP) and UniSource Energy Services (UES). TEP serves more than 414,000 customers in and around Tucson, while UES provides natural gas and electric service to about 243,000 customers in northern and southern Arizona. Electric service is provided through a UES subsidiary called UNS Electric, Inc., while natural gas service is provided through a subsidiary called UNS Gas, Inc.

III. UNS' REQUEST FOR AN ACCOUNTING ORDER

Q. Please provide some more background on the proposed purchase of Gila Unit 3.

A. Based on the Company's application dated December 23, 2013 TEP and UNS entered into an agreement to purchase Gila Unit 3 for $219 million. TEP would acquire a 75 percent or a $164.25 million share, and UNS would acquire a 25 percent or $54.75 million share in Gila Unit 3.

Q. Has TEP asked for an accounting order to defer its 75 percent share or approximate $164 million share in Gila Unit 3?

A. No.

Q. Why?

A. Through conversation and a data response from the Company, TEP due to its greater size is able to absorb the costs without asking for a deferral, and will ask for recovery in its next rate case, under traditional ratemaking.

Q. Does TEP or UNS need Commission approval to purchase Gila Unit 3?

A. No.

Q. Has the UNS already received regulatory approval for the purchase of Gila Unit 3 from Federal Regulatory Energy Commission ("FERC")?

A. Yes.

Q. When does UNS expect to purchase Gila Unit 3?

A. December 10, 2014.

Q. Should the Commission approve an accounting order?

A. Yes. The Commission can deny the Company an accounting order, but RUCO believes that would be unwise. In simple terms, under traditional ratemaking the Company acquires or builds plant between rate cases. Once the normal prudency issues and used and useful issues are reviewed and authorized in the context of a general rate case, the

Company's plant is normally included in rate base, and the Company receives a return of and on its plant investments. In this case, due to the ***significant*** investment in plant for UNS' share, the Company is asking that the timing be changed and the costs that would normally be forgone until the plant is included in rate base under traditional ratemaking in the next rate case be deferred for future recovery.

UNS' is asking for 25 percent of UNS' share of the acquisition to be deferred, while TEP is ***not*** asking for the 75 percent related to TEP's share of the acquisition to be deferred. As RUCO represents ratepayers statewide, RUCO is pleased that the Company is asking for traditional rate making treatment for TEP's customers. Based on RUCO's analysis, RUCO agrees with the Company that the acquisition of Gila Unit 3 will have a significant impact on UNS's financial statements. If an accounting order is not approved, this could affect UNS' financial viability in the future.

Q. What is the purpose of an accounting order?

A. An accounting order is a rate-making mechanism that provides regulated utilities the ability to defer costs that would otherwise be expensed under generally accepted accounting principles. It also permits alternative accounting treatment for capital and other costs as permitted under the FERC Uniform System of Accounts ("USoA"). In other words, UNS cannot request retroactive recovery of these costs. However, the Commission can authorize UNS to defer these costs by approving the accounting order and consider recovery of these costs in a future rate case. The granting of an accounting order is not tacit approval of the costs but has traditionally resulted in Commission approval of the costs in question.

Q. How are the costs authorized for deferral by an accounting order tracked?

A. The deferrals are recorded in a deferral account to maintain a running balance. Then, in a future rate case, the Commission decides whether to include none, some, or all of the costs in rates.

Q. Is the purpose of an accounting order to guarantee recovery of previously incurred and not yet recovered costs or to guarantee recovery of authorized deferrals?

A. No. In the case of an accounting order for cost deferral, the purpose is ***to preserve the opportunity*** to have recovery of certain costs *considered **in the future***. The Commission should not predetermine the recoverability of costs; rather it should allow for post-incurrence review for reasonableness, appropriateness and prudency. This would be determined in the Company's next rate case filing.

Q. Did the Company provide language that it desires to include in its accounting order, and is this consistent with the above discussion?

A. Yes. For convenience, the Company's proposed accounting order language is reproduced here.

IT IS THEREFORE ORDERED that UNS Electric, Inc. is authorized to defer for possible later recovery through rates, all non-fuel costs (as defined herein) of owning, operating and maintaining up to an acquired 25 percent interest in Gila River Power Plant Unit 3 and associated facilities. Nothing in this Decision shall be construed in any way to limit this Commission's authority to review the entirety of the acquisition and to make any disallowances thereof due to imprudence, errors or inappropriate application of the requirements of this Decision.

IT IS FURTHER ORDERED that UNS Electric, Inc. shall reduce the deferrals by any fuel and purchased power savings and off-system sales not otherwise reflected in its Purchased Power and Fuel Adjustment Clause.

IT IS FURTHER ORDERED that the accumulated deferred balance associated with all amounts deferred pursuant to this Decision will be included in the cost of service for rate-making purposes in UNS Electric, Inc.'s next general rate case. Nothing in this Decision shall be construed to limit this Commission's authority to review such balance and to make disallowances thereof due to imprudence, errors or inappropriate allocation of the requirements of this Decision.

IT IS FURTHER ORDERED that UNS Electric, Inc. shall prepare and retain accounting records sufficient to permit detailed review, in a rate proceeding, of all deferred costs and cost benefits as authorized herein.

IT IS FURTHER ORDERED that UNS Electric, Inc. shall prepare a separate detailed report of all costs deferred under this authorization and shall include that report as an integral component of each of its general rate applications in which requests recovery of those deferred costs.

IT IS FURTHER ORDERED that UNS Electric, Inc. shall file an annual status report for each preceding calendar year, of all matters related to the deferrals, and the cumulative costs thereof every April 1 with Docket Control, as a compliance item in this Docket, with the first such report due not later than April 1, 2015.[1]

[1] See pages 7 through 8 of the Company's initial accounting order request dated December 31, 2013.

Q. Since the advent of the Company's initial accounting order request, and Staff's direct testimony have Staff and the Company agreed to any changes in the language of the accounting order?

A. Yes.

Q. Did Staff identify any additional conditions and clarifications that should be reflected in the accounting order?

A. Yes. Staff's proposed accounting order language is reproduced here.

1. That costs subject to deferral be limited to:
   - a. depreciation and amortization costs,
   - b. property taxes,
   - c. O&M expenses, and
   - d. carrying costs[2] associated with owning, operating, and maintaining the plant

2. that certain benefits of owning the plant shall also be deferred,
   - a. the avoided cost of capacity should be based on the readily available market value as proposed by the Company,
   - b. that that the energy savings related to power production at Gila 3 should be calculated based on the difference between the non-firm market price of energy and the fuel cost,
   - c. that the net benefit of any wholesale value arising from the ownership of Gila 3 should also be deferred,

[2] Calculated at 5.0000 percent.

3. that the value of deferred benefits shall be subject to inclusion in the Company's ongoing PPFAC calculations,
4. that the deferred costs and deferred benefits shall be evaluated in a future rate proceeding,
5. that the ratepayers be held harmless for any deferred costs in excess of deferred benefits,
6. that the amount of any deferred benefits in excess of deferred costs shall be used as a reduction to the running balance in the PPFAC arising from non - Gila 3 activity,
7. that any authorizations to defer costs shall be limited to $10.5 million,
8. that any authorizations to defer costs shall expire no later than May 1, 2016. Any expense incurred after April 30, 2016 would not be eligible for deferral.
9. that no prudency determination be made at this time and that the prudency of the purchase of Gila 3 will be determined in a future rate proceeding,
10. that there shall be no carrying costs on any under-recovered PPFAC balance resulting from the purchase of Gila 3,
11. that the Company file a plan of administration within 30 days of the filing of this testimony for consideration and inclusion in the final decision.

Q. Does RUCO disagree with any of the additional language Staff is recommending and the Company has accepted?

A. No.

Q. Does RUCO have any recommendations regarding language that should be included in the accounting order?

A. Yes, as will be discussed later.

IV. RUCO'S ANALYSIS

Q. What Criteria has RUCO used to analyze the Company proposed accounting order?

A. RUCO considered 1) the financial impact of the transaction, and 2) the prior APS accounting order for comparison purposes, and by examining the following factors: Environmental Risk, Decommissioning Costs, the Purchase Power and Fuel Adjustment Clause, the Acquisition Premium or Discount, the Deferral Time Period and Limit on the Deferral Amount, the Added Benefits for Ratepayers, and the Carrying Costs.

1. Financial Impact of the transaction

Q. Has UNS provided any information to assist in an assessment of the impact the proposed accounting order would have on its financial statements?

A. Yes. However, some of this information is confidential. But, based on page

5 of the Company's accounting order request filing, the Company stated that purchase price would represent approximately 28 percent of the Company's rate base approved in its last rate case.

Q. Based on Commission Decision No. 74235, dated September 30, 2013, which was the result of a settlement agreement, and utilized a test year ending December 31, 2012, were you able to extrapolate additional financial information?

A. Yes. The Company stated in a data response that the "Company updated its estimated Unit 3 non-fuel costs for the period January 1, 2015 through April 30, 2016 using a carrying cost of 5.0000% which totaled approximately $10.5 million."

Based on total revenues authorized in the last rate case of $174,637,342, the percent of revenues would be approximately 6 percent (i.e. $10,500,000/$174,637,342).

Similarly based on total operating income authorized in that case of $28,175,500, the percentage of operating income effected by the transaction would be approximately 37 percent (i.e. $10,500,000/$28,175,500).

Q. Based on the financial metrics of the proposed transaction is RUCO in agreement that the investment in Gila Unit 3 is financially significant?

A. Yes.

2. The Prior Arizona Public Service ("APS") Accounting Order

Q. Are you familiar with the one approved in Commission Decision No. 73130 dated April 24, 2012?

A. Yes. I was Staff's witness at the time and presented testimony in that case.

Q. Please provide some background on Decision No. 73130.

A. In that case there were two issues 1) APS needed authorization to purchase Southern California Edison ("SCE") interest in the Four Corners Power Plant (specifically units 4 and 5) which consisted of five coal generating units and 2) an accounting order to defer some of the purchase and operation costs. Ultimately, Decision No. 73130 approved both of APS' requests. As already stated UNS does not need Commission approval to purchase Gila Unit 3, so I will focus the rest of the discussion on the second issue which is the accounting order.

Q. Are the deferral items[3] that UNS is requesting to defer similar if not the same to the deferral items approved in the APS case?

A. Yes, and UNS has acknowledged it modeled its accounting order language after the language used in Decision No. 73130.[4]

<u>**Environmental Risk**</u>

Q. Environmental risks have become an issue not just for Utility Companies, but also for ratepayers in which the Utility Companies pass through these costs to ratepayers in the form of surcharges.[5] Please discuss any Environmental risks associated with UNS' purchase of Gila Unit 3.

A. Based on a RUCO data request sent to UNS, the Company identified the following two areas of concern:

"There are two pending regulations we are aware of that may be applicable to Gila 3:

1) The proposed New Source Performance Standard for carbon dioxide emitted from existing power plants ("CO2 NSPS"). Gila 3, as a natural

[3] Depreciation and amortization costs; property taxes; O&M expenses; carrying costs associated with owning, operating and maintain the plant, and other non-fuel plant costs.
[4] See page 7, line 15 of the Company's application.
[5] See APS' Federal Environmental Improvement Surcharge from their website, which recovers a portion of the cost of investments and expenses for environmental improvements at their generating facilities in order to comply to environmental standards mandated by federal law and regulations.

gas combined cycle plant emits carbon dioxide and will be subject to the regulation. UNS Electric anticipates that impacts on Gila 3 operations will be minimal as the proposed rule primarily targets coal fired sources of carbon dioxide. Given the fact that the rule will not be finalized until mid-2015, the impact of the proposed regulation is unknown at this time.

2) EPA is currently considering revising the National Ambient Air Quality Standard for Ozone ("Ozone NAAQS"). If the standard is revised lower, the State Implementation Plan may require reduction of nitrogen oxides ("NOx") in non-attainment areas. Gila 3 is a source of NOx (a precursor to ozone), however as a currently permitted source, UNS Electric does not expect that any reductions will be necessary at Gila 3."

Further, "Cost of compliance with the CO2 NSPS and/or the Ozone NAAQS is unknown at this time but UNS Electric does not anticipate any significant cost or material operational changes associated with the implementation of these regulations."

Based on the responses the Company indicates that any Environmental risks at this time would be minimal.

Contrasted to the APS case, in which APS knew about several pending EPA regulation and had actual estimated compliance costs in excess of $660 million.[6]

All other things being equal the less Environmental risk the less potential costs that will be passed onto ratepayers, which is a benefit to ratepayers.

Decommissioning Costs

Q. Please discuss the issue of decommissioning costs?

A. Based on a RUCO data request sent to the UNS, the Company responded as follows:

"Yes, the Company expects to incur future decommissioning costs for Gila 3. The Company has not prepared a decommissioning study for Gila 3, but expects the costs to be similar to the Luna Energy Facility owned by TEP."

Both APS and UNS have decommission costs associated with their acquisition purchases. These decommissioning costs will add to the long-term cost of the asset, but the Company is not asking to defer these costs in the accounting order.

[6] See page 3, line 12 of Decision No. 73130.

<u>Purchase Power and Fuel Adjustment Clause ("PPFAC")</u>

Q. Please explain what the PPFAC is and how it works?

A. In order to reduce UNS' volatility in fuel and power costs between rate cases the Commission has authorized the use of a PPFAC.

The Company in a data request response to RUCO stated that "UNS uses a historical 12 month rolling average of actual fuel, purchased power and wheeling costs less revenues from short-term wholesale sales to set a PPFAC rate. The PPFAC rate is adjusted on a monthly basis."

Q. How will the purchase of Gila Unit 3 effect the Company's PPFAC?

A. The Company in a data request response to RUCO stated that "by acquiring an interest in Unit 3, UNS Electric will meet a portion of its retail load with output from the plant and reduce its reliance on the market for purchased energy and capacity. As a result, the costs recovered through generation, net of revenues from short-term wholesale sales, is expected to be less than the costs that otherwise would have been incurred to purchase energy and capacity."

It appears from the Company's analysis that by purchasing Gila Unit 3, ratepayers will benefit through the PPFAC.

Q. Originally, UNS wanted to run any cost savings immediately through the PPFAC, but have now agreed with Staff to defer this savings, in order to stabilize customers' bills in the future. Is this your understanding?

A. Yes, and RUCO is not opposed to this.

<u>Acquisition Premium or Discount</u>

Q. Please define what is meant by an acquisition premium or discount?

A. A premium or discount is calculated by taking the purchase price less the net book value (asset – accumulated depreciation). If the value is negative a discount results and if the value is positive a premium results.

Q. What is the amount of the acquisition premium or discount in this case?

A. UNS estimates a $50.4 million ***discount*** of which $12.6 million relates to UNS' purchase.

Q. In the APS case was there an acquisition premium or discount?

A. In the APS case there was an acquisition ***premium*** of approximately $252 million, in other words the Company paid more than the assets were worth.[7]

[7] See the Surrebuttal Testimony of RUCO witness Robert B. Mease, page 3, line 17 in Docket No. E-01345A-11-0224.

All other things being equal ratepayers benefit from an acquisition discount as in this case as opposed to acquisition premium.

Deferral Time Period and Limit on Deferral Amount

Q. To your knowledge has Staff and the Company agreed to a deferral time period which would include the months of January 1, 2015 through April 30, 2016, and limit the amount of the deferral to $10.5 million dollars?

A. Yes.

Q. Was there a limit on the amount that could be deferred in the APS case?

A. No.

Ratepayers benefit from caps on both the deferral time period and amounts that can be deferred.

Added Benefits for Ratepayers

Q. As mentioned earlier in Staff's recommendations, Staff has included additional provisions to protect ratepayers, please comment.

A. Condition 5, states that ratepayers shall be held harmless for any deferred costs in excess of deferred benefits, and condition 10, states that there shall be no carrying costs on any under-recovery of the PPFAC balance resulting from the purchase of Gila 3.

Carrying Cost

Q. Has the Company asked for a carrying cost to be applied to the deferral balance?

A. Yes, originally the Company asked for an average cost of debt of 5.97 percent, but has agreed with Staff and has lowered this cost to 5.0000 percent.

Q. Has RUCO confirmed this percentage?

A. Yes.

Q. In the APS case did the Company request a carrying costs on the deferral?

A. Yes the Company asked not only for a debt component, but also an equity component of 11.00 percent.[8]

Q. What was the final determination in Decision No. 73130?

A. The Commission Order allowed for the documented debt costs of acquiring SCE's interest in units 4 and 5.

Obviously the lower the carrying costs the greater the benefits to ratepayers.

[8] The final determination in Decision No. 73130 allowed for the documented debt costs of acquiring SCE's interest units 4 and 5.

Q. What is RUCO's recommendation regarding the carrying costs of 5.0000 percent requested by the Company in this case?

A. RUCO does not oppose a carrying cost of 5.0000 percent.

Q. But wait, isn't this contrary to your position in the APS case?

A. In light of the stark differences between the APS case and this case, and the superior benefits that will be passed onto ratepayers, as will be discussed in the conclusion section, RUCO believes a 5.0000 percent carrying cost to be appropriate in this case, and in this case only. ***Stated another way this may or may not be RUCO's position to include a carrying cost in the Company's next accounting order, or in any other utility companies accounting order in the future (emphasis added).***

V. RUCO's ACCOUNTING ORDER LANGUAGE RECOMENDATION

Q. Is there any language that RUCO would like to see incorporated into the accounting order?

A. Yes. RUCO would like to incorporate the following language into the accounting order:

IT IS FURTHER ORDERED that in the event a settlement agreement is reached in UNS Electric, Inc.'s next rate case, any changes to the deferral order including changes to the carrying costs shall be thoroughly explained in the settlement agreement.

Q. Why does RUCO consider this additional language important?

A. RUCO, Staff, and APS just finished a hearing involving what the carrying costs and deferral amount on the Four Corners deferral should be.[9] In order, to avoid litigation, and a lengthy time consuming hearing, RUCO recommends the additional paragraph as recommended be inserted into the accounting order.

VI. OTHER ISSUES

Q. Has the Company put forth a draft Plan of Administration?

A. Yes, as recommended by Staff.

VII. CONCLUSION

Q. Please summarize why RUCO believes this accounting order should be approved with the additional language added to the accounting order.

A. In summary RUCO believes the Accounting Order should be approved for the following reasons:

a. UNS' is asking for 25 percent of UNS' share of the acquisition to be deferred, while TEP is ***not*** asking for the 75 percent related to TEP's share of the acquisition to be deferred. As RUCO represents

[9] See Docket No. E-01345A-11-0224. In addition, there still has not been a Commission Decision on what the carrying cost and amount should be in that case.

ratepayers statewide, RUCO is pleased that the Company is asking for traditional rate making treatment for TEP's customers.

b. Based on RUCO's analysis, RUCO agrees with the Company that the acquisition of Gila Unit 3 will have a significant impact on UNS's financial statements. If an accounting order is not approved, this could affect UNS' financial viability in the future.

c. The environmental risks are less for a combined cycle natural gas-fired unit then a coal fired unit, and the lower environmental risks will benefit both UNS and its ratepayers.

d. UNS is not requesting deferral of decommissioning costs.

e. It is expected that ratepayers will benefit through UNS' PPFAC.

f. The transaction will result in an acquisition discount, which benefits to both UNS and its ratepayers.

g. There is a deferral time period and limitation on the amount that can be deferred.

h. Rate payers shall be held harmless for any deferred costs in excess of deferred benefits, and there shall be no carrying costs on any under-recovered PPFAC balance resulting from the purchase of Gila Unit 3.

i. Although RUCO generally does not approve of carrying costs, RUCO believes a carrying cost of 5.0000 percent is reasonable ***in this case and this case only*** for the reasons cited in a. through h.

Q. Does this conclude your direct testimony?

A. Yes.