

BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER

Chairman

WILLIAM A. MUNDELL

Commissioner

JEFF HATCH-MILLER

Commissioner

MIKE GLEASON

Commissioner

KRISTIN K. MAYES

Commissioner

IN THE MATTER OF THE APPLICATION OF) DOCKET NO. E-01345A-03-0437
ARIZONA PUBLIC SERVICE COMPANY FOR A)
HEARING TO DETERMINE THE FAIR VALUE)
OF THE UTILITY PROPERTY OF THE)
COMPANY FOR RATE MAKING PURPOSES, TO)
FIX A JUST AND REASONABLE RATE OF)
RETURN THEREON, TO APPROVE RATE)
SCHEDULES DESIGNED TO DEVELOP SUCH)
RETURN, AND FOR APPROVAL OF)
PURCHASED POWER CONTRACT)
_____)

DIRECT TESTIMONY

IN SUPPORT OF THE PROPOSED SETTLEMENT AGREEMENT

ERNEST G. JOHNSON

DIRECTOR

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

SEPTEMBER 27, 2004

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EXECUTIVE SUMMARY
ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. E-01345A-03-0437

Mr. Johnson provides policy level testimony which summarizes the Settlement process, provides reasons which support Staff's conclusions that the Settlement Agreement is in the public interest and addresses several general policy considerations. Mr. Johnson concludes that the Settlement Agreement is fair, balanced and in the public interest. Mr. Johnson asserts the following as support for Staff's conclusion that the Settlement Agreement is in the public interest:

- Staff believes that the agreement is fair to ratepayers because it precludes inappropriate utility profits and results in just and reasonable rates for consumers.
- Staff believes that it is fair to the utility because it provides revenues necessary for the utility to provide reliable electric service along with an opportunity for a reasonable profit.
- Staff believes that this proposal balances many diverse interests including those of low income customers, the renewable energy sector, DSM advocates, merchant generators and retail energy marketers.
- Staff believes that the Agreement is in the public interest because it allows APS to rate base the PWEC Assets, which are the generating plants originally built by APS' affiliate Pinnacle West Energy Corporation, at a value significantly below their book value.
- Although the Agreement calls for rate basing the PWEC Assets, it also addresses potentially anti-competitive effects associated with such rate basing. The Agreement adopts a self-build moratorium, provides for a competitive solicitation in 2005, and requires Staff to conduct workshops to address future resource planning and acquisition issues. In addition, the rate design section encourages general service customers, which are the customers most attractive to new competitors, to shop for competitive services by adopting cost-based unbundling for generation and revenue cycle services. These provisions are intended to promote competition.
- Staff believes that the Settlement eliminates long, complex litigation by resolving issues associated with prior Commission decisions that are currently on appeal (Track A and certain rate case issues). If the Agreement is approved, these appeals will be dropped.
- Staff believes that the Agreement promotes the public interest by facilitating the provision of reliable electric service at the lowest reasonable rates.

- The Agreement provides additional discounts to low-income APS customers, increases funding for advertising these discounts, and increases funding for APS' low-income weatherization program.
- The Agreement sets forth a comprehensive DSM proposal, which is intended to foster the development of new DSM programs. Significantly, the DSM section of the Agreement also includes provisions to ensure that DSM expenditures will be reasonable and that the Commission will be able to maintain appropriate oversight.

Finally, in concluding that the Settlement Agreement is in the public interest, Mr. Johnson notes that the Agreement addresses and resolves all of the main rate case issues, provides sufficient revenues and return for APS to maintain reliable electric service and results in rates and charges which Staff believes are just and reasonable.

INTRODUCTION/SUMMARY

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Q. Please state your name and business address.

A. My name is Ernest G. Johnson, 1200 West Washington Street, Phoenix, Arizona 85007.

Q. By whom are you employed and in what capacity?

A. I am employed by the Arizona Corporation Commission (“ACC” or “Commission”) as the Director of the Utilities Division.

Q. Briefly describe your responsibilities as Utilities Director.

A. I am responsible for the day-to-day operations of the Utilities Division, including policy development, case strategy and overall Division management.

Q. Please summarize your educational background and professional experience.

A. In 1979 and 1982, respectively, I earned Bachelor of Science and Juris Doctorate degrees, both from the University of Oklahoma. I have been involved in the regulation of public utilities since 1986. I was employed by the Oklahoma Corporation Commission in 1986 in various legal capacities. In 1993, I was named acting Director and served in that position until mid-1994. I served as permanent Director from mid-1994 until October 2001. In October of 2001, I assumed my current position with the Arizona Corporation Commission. While serving in these capacities, I have participated in numerous regulatory proceedings including providing policy analysis concerning Electric Restructuring before the Oklahoma Corporation Commission, the Oklahoma State Legislature, and the Arizona Commission.

1 **Q. Did you participate in the negotiations that led up to the execution of the Proposed**
2 **Agreement?**

3 A. Yes, I did.
4

5 **Q. What is the purpose of your testimony in this case?**

6 A. I will provide testimony which addresses the settlement process, public interest and
7 general policy considerations.
8

9 **Q. How is your testimony being presented?**

10 A. My testimony is organized into three sections. Section I provides discussion and insight
11 into the Settlement process. Section II identifies and discusses the reasons why the
12 Settlement Agreement (“Agreement”) is in the public interest. Section III addresses
13 several general policy considerations.
14

15 **Q. Who else is providing Staff testimony and what issues will they address?**

16 A. Staff will present the following witnesses:

- 17
- 18 • Ms. Linda Jaress provides testimony explaining why approval of the
19 Settlement Agreement is in the public interest and why Staff entered the
20 Agreement.
21
 - 22 • Mr. Matt Rowell provides testimony in the form of a Staff report concerning
23 the treatment of certain PWECC generation assets and the treatment of
24 competitive issues.
25
 - 26 • Ms. Barbara Keene provides testimony in the form of a Staff report covering
27 Demand Side Management, Renewables and Distributed Generation. Ms.
28 Keene also addresses the low-income programs, adjustor mechanisms and
29 service schedules.
30
 - 31 • Mr. Bob Gray provides testimony in the form of a Staff report which
32 principally addresses various adjustment Mechanisms.
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 - 34 • Ms. Erinn Andreasen provides testimony in the form of a Staff report
35 concerning Rate Design.

SECTION I - SETTLEMENT PROCESS

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Q. Please discuss the Settlement process.

A. In my 18 years of experience in utilities regulation, this process was unprecedented and unparalleled in its breadth and scope. There were more than 30 parties representing every possible viewpoint – advocates for consumers, including low-income customers and seniors; advocates for retail competition, and even other utilities. Working together over the past approximately four months, we have managed to craft a proposed solution that satisfies nearly all of those diverse interests. If we were unable to resolve a specific issue, we set up a process for that issue to be examined and addressed in the future.

Q. How many Settlement meetings were held?

A. During the period of April 19, 2004 through August 11, 2004, approximately twenty (20) meetings were held.

Q. Who participated in those meetings?

A. Generally, most interests were represented; attendees included Arizona Public Service Company (“APS”), Residential Utility Consumer Office (“RUCO”), Staff, and most intervenors.

Q. Could you identify some of the diverse interests that were involved in this process?

A. Yes. Diverse interests included consumer representatives, merchant plants, large customers of APS, solar interests, environmental interests, and demand side management (“DSM”) advocates, just to name a few.

Q. How many of these parties executed the stipulation?

A. The Agreement was executed by twenty-two (22) parties.

1 **Q. How many parties did not sign the Agreement, but nonetheless do not oppose the**
2 **Agreement?**

3 A. There are five parties who I would describe as not opposed but not signing the Agreement.
4

5 **Q. How many parties oppose the Agreement?**

6 A. Only one party stated its opposition to the Agreement.
7

8 **Q. Who is that party?**

9 A. The Arizona Cogeneration Association (“ACA”).
10

11 **Q. Why is Arizona Cogeneration Association opposing the Agreement?**

12 A. It is my understanding that the ACA believes that certain rate structures contained within
13 the Agreement do not encourage distributed generation.
14

15 **Q. In your opinion, was there an opportunity for all issues to be discussed and**
16 **considered?**

17 A. Yes. In my opinion, the issues of concern to the ACA were seriously considered, certainly
18 by Staff. Unfortunately, up to this point, we have been unable to resolve them.
19 Nonetheless, the Agreement provides for a process designed to facilitate further discussion
20 and hopefully resolution of these issues.
21

22 **Q. Mr. Johnson, what process are you referring to?**

23 A. I am referring to Section XVII of the Agreement which provides that the ACC Staff will
24 schedule workshops to consider outstanding issues affecting distributed generation. The
25 Agreement further provides for the initiation of a rule making proceeding as may be
26 necessary.

1 **Q. How would you describe the negotiations?**

2 A. I believe that all participants zealously advocated and represented the interests of their
3 constituents. As might be expected, at times the discussions became quite contentious and
4 global resolution of the multitude of very complex issues appeared to be no more than
5 wishful thinking. However, I am extremely pleased with the desire and effort put forth by
6 all parties. While acknowledging that not all parties executed the Agreement, I must note
7 that all parties had the opportunity to be heard and to have their issues fairly considered.
8

9 **Q. Mr. Johnson, would you describe the process as requiring a lot of give and take?**

10 A. Yes, I would. As a result of the many and varied interests represented in the Settlement
11 process, a willingness to compromise was absolutely necessary. As evidenced in the
12 Agreement, the signatories compromised vastly different litigation positions.
13

14 **Q. In your previous response, you stated that the parties compromised litigation
15 positions. Is that correct?**

16 A. Yes.
17

18 **Q. In your opinion, was the public interest unduly compromised?**

19 A. No, not in my opinion. As I will discuss later in this testimony, I believe that the
20 compromises made by the various parties will actually further the public interest.
21

22 **Q. Mr. Johnson, are there any other comments you would like to make in regard to the
23 Settlement process?**

24 A. Yes. I am very pleased with the outcome of the negotiations and I want very much to
25 thank all parties for their diligent participation in the process. It was difficult at times to
26 ensure that all parties had an opportunity to be fully aware of all discussions among and

1 between participants, especially when some were interested in very narrow issues. In fact,
2 at times, it appeared that extreme efforts were being undertaken to provide opportunities
3 for participation.
4

5 **SECTION II - PUBLIC INTEREST**

6 **Q. Turning now to the issue of public interest. Mr. Johnson, in Staff's opinion, is the**
7 **Proposed Settlement in the public interest?**

8 A. Yes, absolutely. In Staff's opinion, the Proposed Settlement is fair, balanced and in the
9 public interest.
10

11 **Q. Mr. Johnson, would you briefly summarize the reasons that Staff concludes that the**
12 **Settlement is fair, balanced and in the public interest.**

13 A. Yes, the following points support Staff's view:

- 14
- 15 • Staff believes that the agreement is fair to ratepayers because it precludes
16 inappropriate utility profits and results in just and reasonable rates for consumers.
17
- 18 • Staff believes that it is fair to the utility because it provides revenues necessary for the
19 utility to provide reliable electric service along with an opportunity for a reasonable
20 profit.
21
- 22 • Staff believes that this proposal balances many diverse interests including those of low
23 income customers, the renewable energy sector, DSM advocates, merchant generators
24 and retail energy marketers.
25
- 26 • Staff believes that the Agreement is in the public interest because it allows APS to rate
27 base the PWEC Assets, which are the generating plants originally built by APS'
28 affiliate Pinnacle West Energy Corporation, at a value significantly below their book
29 value.
30
- 31 • Although the Agreement calls for rate basing the PWEC Assets, it also addresses
32 potentially anti-competitive effects associated with such rate basing. The Agreement
33 adopts a self-build moratorium, provides for a competitive solicitation in 2005, and
34 requires Staff to conduct workshops to address future resource planning and
35 acquisition issues. In addition, the rate design section encourages general service

1 customers which are the customers most attractive to new competitors, to shop for
2 competitive services by adopting cost-based unbundling for generation and revenue
3 cycle services. These provisions are intended to promote competition.
4

- 5 • Staff believes that the Settlement eliminates long, complex litigation by resolving
6 issues associated with prior Commission decisions that are currently on appeal (Track
7 A and certain rate case issues). If the Agreement is approved, these appeals will be
8 dropped.
9
- 10 • Staff believes that the Agreement promotes the public interest by facilitating the
11 provision of reliable electric service at the lowest reasonable rates.
12
- 13 • The Agreement provides additional discounts to low income APS customers, increases
14 funding for advertising these discounts, and increases funding for APS' low-income
15 weatherization program.
16
- 17 • The Agreement sets forth a comprehensive DSM proposal, which is intended to foster
18 the development of new DSM programs. Significantly, the DSM section of the
19 Agreement also includes provisions to ensure that DSM expenditures will be
20 reasonable and that the Commission will be able to maintain appropriate oversight.
21

22
23 **Q. Turning to your first point, you suggest that the Settlement precludes inappropriate**
24 **utility profits and results in just and reasonable rates for consumers. Please explain.**

25 A. Yes. APS filed its Application seeking to increase base rates by approximately \$166.8
26 million and to recover approximately \$8.3 million through a Competition Rules
27 Compliance Charge ("CRCC") surcharge. Under the Settlement, the base rate increase is
28 reduced by approximately \$100 million. The proposed Agreement provides for a modest
29 increase in base rates of approximately \$67.6 million and a CRCC surcharge of \$7.9
30 million. The proposed revenue requirement contained in the Settlement is approximately
31 60 percent less than the revenue requirement requested by the Company (4.21 percent
32 increase in lieu of a 9.8 percent increase). This Agreement allows ratepayers to keep very
33 significant amounts of money in their pockets.

1 **Q. Please discuss how the Settlement is fair to the utility.**

2 A. Staff believes that the Agreement is fair to the utility because it provides an opportunity
3 for APS to earn revenues sufficient for the utility to provide reliable electric service and to
4 achieve a reasonable profit. Illustratively, the Settlement would provide APS with
5 revenues which would allow it an opportunity to earn an overall rate of return of
6 approximately 5.97 percent and a 10.25 percent return on equity. In Staff's opinion, these
7 returns would enable APS to provide reliable service at reasonable rates.

8
9 **Q. Mr. Johnson, you have indicated that the Settlement Proposal incorporates many**
10 **diverse interests including those of low-income customers, the renewable energy**
11 **sector, DSM advocates, merchant generators and retail energy marketers. Please**
12 **elaborate.**

13 A. Within the Agreement, there are specific provisions which address many of the concerns
14 expressed by the above-referenced interests. By way of example, I would submit the
15 following:

16
17 **Competitive Procurement of Power**

18 This issue is more fully addressed in the Staff Report of Mr. Matt Rowell. But as he
19 generally notes, in order to settle matters relating to competition and the procurement of
20 APS' power from the competitive market, the Parties agreed that APS would not build
21 new, large central station generation with an in-service date before 2015. The self build
22 moratorium is subject to a safety mechanism that permits APS to seek an exemption from
23 the Commission if the wholesale market cannot cost effectively meet the needs of APS'
24 customers. These provisions are designed to retain the opportunity for the competitive
25 power marketplace to meet some of APS' generation needs. In my view, over time, and as

1 an outgrowth of this Settlement, we will be able to better assess the ability of the
2 marketplace to provide reliable, reasonably priced generation to APS' rate payers.

3
4 **Renewable Energy**

5 Under the Agreement, APS has committed to issuing a Request for Proposal in 2005
6 seeking at least 100 MW and 250,000 MWh per year of electricity generated by solar,
7 biomass/biogas, wind, small hydro, hydrogen or geothermal resources. This provision
8 should provide an opportunity for renewable sources to further demonstrate value as a
9 reliable component of the generation portfolio of APS.

10
11 **Demand Side Management**

12 Many parties had a particular interest in the issue of DSM. The Agreement calls for a
13 large increase in expenditures for energy efficiency DSM which would include up to \$1.0
14 million which could be used for low-income weatherization projects/programs. Staff
15 places the highest priority on programs to develop energy efficient schools during new
16 construction and by retrofitting. By utilizing energy efficient DSM programs, schools will
17 be able to lower utility bills, thereby freeing up additional dollars for student education
18 and teacher pay. This ultimately could translate into savings for taxpayers.

19
20 **Q. How does the Agreement address regulatory issues and unification of assets as it
21 relates to the Pinnacle West Energy Corporation ("PWEC") Assets?**

22 **A.** The PWEC assets being transferred consist of the West Phoenix 4 and 5, Saguaro 3, and
23 Redhawk 1 and 2 generating plants. In its application, APS requested approval to acquire
24 the PWEC assets and to receive rate base treatment of the assets at their book value of
25 \$883.0 million. The Agreement proposes the transfer of the assets to APS and inclusion in
26 rate base at the reduced amount of \$700.00 million. Thus, the Company's concern

1 regarding unification of assets and the regulatory treatment accorded to those assets will
2 be known and certain.

3
4 **Q. Mr. Johnson, you suggested that the Agreement is in the public interest because if**
5 **approved, it would eliminate long, complex litigation. Please explain.**

6 A. With Commission approval of the Agreement, several legal matters would be settled. The
7 Parties agreed that the Preliminary Inquiry regarding APS compliance with the Electric
8 Competition Rules would be concluded without further action by the Commission. Upon
9 approval of the Agreement, APS and its affiliates will forego any claim that they were
10 harmed by Commission Decision No. 65154 (the Track A Decision). Furthermore, APS
11 would dismiss with prejudice all of its appeals of Decision No. 65154 and all litigation
12 related to Decision Nos. 65154 and 61973. In Staff's view, continued litigation along with
13 the risks attendant thereto, could result in increased costs to rate payers without any
14 recognizable benefits.

15
16 **Q. Please discuss your contention that the Agreement promotes the public interest by**
17 **facilitating reliable electric service at the lowest reasonable rates.**

18 A. As previously stated, the Settlement would allow APS the opportunity to earn an overall
19 return of 5.79 percent and a 10.25 percent return on equity. In Staff's opinion, APS
20 should have sufficient revenues and reasonable access to capital, which will allow it to
21 properly maintain its system and provide reliable electric service.

22
23 **Q. What impact will the Settlement have on low-income customers?**

24 A. As previously stated, the Agreement calls for a modest base rate increase. It was the
25 parties' intent to insulate eligible low-income customers from a rate increase. As a result,

1 if the Agreement is approved, nearly all low-income customers would receive a net
2 reduction in rates.

3
4 **Q. Please explain.**

5 A. Basically, the Agreement adopts a higher rate discount for this group. Illustratively,
6 qualifying low-income customers using 401 to 800 kWh currently receive a 20 percent
7 discount. The discount would increase from 20 percent to 26 percent and would
8 completely offset any increase that the eligible low-income customer may have
9 experienced. This increased discount would be in addition to the approximate \$1.0
10 million available through the DSM allowance to be used for low-income weatherization
11 programs and bill assistance.

12
13 **SECTION III - POLICY CONSIDERATIONS**

14 **Q. Mr. Johnson, in its direct testimony, did Staff recommend against including the**
15 **PWEC generation assets in rate base?**

16 A. Yes.

17
18 **Q. Is it not true that the Proposed Agreement provides for rate base inclusion of those**
19 **assets?**

20 A. Yes.

21
22 **Q. Could you discuss why Staff withdrew its opposition to rate basing the PWEC**
23 **generation units?**

24 A. Yes. In its initial testimony, Staff challenged APS to properly support its request to
25 include the five new power plants in rate base. In the absence of persuasive testimony to
26 move the plants into rate base in APS' original application, Staff was compelled to

1 recommend against inclusion. To its credit, in its rebuttal case, APS provided additional
2 data and made additional arguments. These submittals, while not being conclusive as to
3 the issue of the appropriate treatment of the PWEC assets, did warrant further analysis and
4 serious consideration by Staff. However, among other things, Staff still questioned the
5 valuation of the generating plants. Staff was able to reconcile its initial opposition when
6 APS agreed to a significantly reduced valuation and when APS agreed to forego claims to
7 \$234 million, which APS had alleged it should recover from ratepayers as a result of the
8 Track A order.

9
10 **Q. Were there additional reasons?**

11 A. Yes. As more fully discussed in the testimony of Mr. Matt Rowell, the Agreement
12 provides for substantial commitments by APS to market-based approaches aimed at
13 meeting future capacity needs. It is anticipated that the self build moratorium and RFP
14 commitments set forth in Section IX of the Agreement will expand the competitive
15 alternatives available to APS. Finally, in reviewing the totality of the Proposed
16 Agreement, Staff was persuaded that on balance inclusion of the PWEC assets as outlined
17 above was not inappropriate.

18
19 **Q. Mr. Johnson, how does Staff reconcile moving from a rate reduction scenario to a
20 rate increase scenario?**

21 A. The testimony of Ms. Linda Jaress offers a more complete discussion of the basis for the
22 revenue requirement set forth in the Agreement. In this testimony, I address the policy
23 reasons underlying Staff's change in position. As a policy matter, the single most
24 significant revenue requirement issue was determining the appropriate regulatory
25 treatment to be afforded to the PWEC assets. The revenue requirement associated with
26 these generation plants was approximately \$100 million annually. As stated previously,

1 Staff's initial testimony challenged APS to properly support its request to include the five
2 power plants in its rate base. In our view, the Company's initial testimony failed to
3 demonstrate that inclusion of those assets was the best option for ratepayers, especially at
4 the valuation proposed by the Company. In the absence of persuasive testimony
5 supporting inclusion (in addition to other accounting adjustments), Staff was compelled to
6 recommend a rate decrease.

7
8 **Q. Does the Agreement strike an appropriate balance between the diverse needs of the**
9 **interested parties?**

10 A. Yes. Staff believes that the Agreement as a whole mitigates the impact on ratepayers
11 associated with rate basing the PWEC assets and balances the potentially anti-competitive
12 effects of rate basing with certain pro-competitive provisions. The ratepayer impact is
13 mitigated because the assets are being added to the rate base at a value substantially less
14 than their book value. Also, because the Settlement provides for APS to drop its pending
15 Track A related lawsuits against the Commission, rate payers will not face the risk of
16 having to fund a \$234 million (or more) judgment in APS' favor.

17
18 **Q. As a policy matter, why should the Commission approve the Settlement Agreement?**

19 A. The Settlement Agreement addresses and resolves all of the major rate case issues and
20 results in rates which we believe are just and reasonable. Staff believes that the agreed
21 upon revenue requirement is sufficient for APS to maintain reliable service to its
22 customers and to provide a fair return to its investors while causing only a modest increase
23 in rates.

24
25 **Q. Does this conclude your direct testimony?**

26 A. Yes, it does.