

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

3 MARC SPITZER, Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 MIKE GLEASON
7 KRISTIN K. MAYES

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Arizona Corporation Commission
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8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA PUBLIC SERVICE COMPANY FOR
10 APPROVAL OF ADJUSTMENT MECHANISMS.

DOCKET NO. E-01345A-02-0403

DECISION NO. 66567

OPINION AND ORDER

11 DATE OF HEARING: April 3, (pre-hearing conference), April 7, and 8, 2003
12 PLACE OF HEARING: Phoenix, Arizona
13 ADMINISTRATIVE LAW JUDGE: Lyn Farmer
14 APPEARANCES: Mr. C. Webb Crockett, FENNEMORE CRAIG, P.C., on
15 behalf of Arizonans for Electric Choice and
16 Competition;
17 Mr. Thomas L. Mumaw, PINNACLE WEST CAPITAL
18 CORPORATION, on behalf of Arizona Public Service
19 Company;
20 Mr. Scott S. Wakefield, Chief Counsel, on behalf of the
21 Residential Utility Consumer Office; and
22 Ms. Janet Wagner and Mr. Jason Gellman, Staff
23 Attorneys, Legal Division, on behalf of the Utilities
24 Division of the Arizona Corporation Commission.

25 **BY THE COMMISSION:**

26 On May 31, 2002, Arizona Public Service Company ("APS") filed with the Arizona
27 Corporation Commission ("Commission") an application for approval of rate adjustment
28 mechanisms.

On June 10 and 21, 2002, the Residential Utility Consumer Office ("RUCO") and Panda Gila
River, L.P. ("Panda") respectively, filed Motions to Intervene.

On July 16, 2002, RUCO and Panda were granted intervention.

On November 6, 2002, Arizonans for Electric Choice and Competition ("AECC") requested
intervention.

1 On August 30, 2002, the Utilities Division Staff ("Staff") of the Commission filed a Motion
2 to Suspend the Proceeding ("Motion"). The Motion requested suspension of the matter until the
3 completion of Track B of the Generic Proceeding Concerning Electric Restructuring. Staff stated that
4 its analysis of the adjustor might be affected by the outcome of Track B, and because APS cannot
5 benefit from its proposed adjustor mechanism until the conclusion of its next rate case, which would
6 not be filed until June 30, 2003, suspending the adjustor proceeding would not prejudice APS.

7 On September 9, 2002, RUCO filed its response in support of Staff's Motion.

8 On September 11, 2002, APS filed its response, stating it would not oppose a limited
9 extension of the deadline for completing the proceeding, but that it would not support an indefinite
10 suspension.

11 On September 23, 2002, Staff filed its reply requesting that the Commission suspend the
12 deadline and set the matter for hearing sometime in April, 2003. Staff believed that this matter could
13 then be concluded before the start of APS' next rate case.

14 On December 4, 2002, APS filed its supplemental response. APS stated that it no longer
15 opposed Staff's Motion and asked for a Procedural Order "suspending the December 31, 2002
16 'deadline' and setting an evidentiary hearing for sometime in April 2003."

17 On December 10, 2002, a Procedural Order was issued which granted intervention to AECC;
18 set the date for hearing to commence on April 7, 2003; and also listed deadline dates for the filing of
19 testimony, briefs, publication and discovery.

20 On January 17, 2003, APS filed proof of publication of notice of the application and hearing,
21 in compliance with the December 10, 2002, Procedural Order. APS published notice of the
22 application and hearing in the *Arizona Republic* on December 30, 2002, and also provided the notice
23 as a bill insert during its January and February billing cycles.

24 The hearing was held as scheduled on April 7 and 8, 2003, with Alan Propper, David Rumolo,
25 and Donald Robinson testifying on behalf of APS; Marylee Diaz Cortez testifying on behalf of
26 RUCO; Kevin Higgins testifying on behalf of AECC; and Linda Jaress, Barbara Keene, John
27 Thornton, and Erinn Andreasen testifying on behalf of Staff.

28 Post hearing Initial Briefs were filed on May 2, 2003 and Reply Briefs were filed on May 15,

1 2003.

2 INTRODUCTION

3 In Decision No. 61973 (October 6, 1999), the Commission adopted the APS Settlement
4 Agreement as modified. Section 2.6 of the Settlement Agreement provides that:

5 [n]otwithstanding the rate reduction provisions stated above, the Commission
6 shall, prior to December 31, 2002, approve an adjustment clause or clauses which will
7 provide full and timely recovery beginning July 1, 2004, of the reasonable and prudent
8 costs of the following:

9
10 (1) APS' 'provider of last resort' and Standard Offer obligations for
11 service after July 1, 2004, which costs shall be recovered only from
Standard Offer and 'provider of last resort' customers;

12 (2) Standard Offer service to customers who have left Standard Offer
13 service or a special contract rate for a competitive generation supplier but
14 who desire to return to Standard Offer service, which costs shall be
recovered only from Standard Offer and 'provider of last resort' customers;

15 (3) Compliance with the Electric Competition Rules or Commission-
16 ordered programs or directives related to the implementation of the Electric
17 Competition Rules, as they may be amended from time to time, which costs
18 shall be recovered from all customers receiving services from APS,
provided however, that no more than sixty-seven percent (67%) of the costs
19 to transfer generation assets to an affiliate or affiliates shall be allowed to
be deferred for future collection under this provision; and¹

20 (4) Commission-approved system benefit programs or levels not
21 included in Standard Offer rates as of June 30, 1999, which costs shall be
recovered from all customers receiving services from APS.

22 By June 1, 2002, APS shall file an application for an adjustment clause or
23 clauses, together with a proposed plan of administration, and supporting testimony.
24 The Commission shall thereafter issue a procedural order setting such adjustment
25 clause application for hearing and including reasonable provisions for participation by
26 other parties. The Commission order approving the adjustment clauses shall also
27 establish reasonable procedures pursuant to which the Commission, Commission Staff

28 ¹ From the Addendum to Settlement Agreement dated November 24, 1999.

1 and interested parties may review the costs to be recovered. By June 30, 2003, APS will
 2 file its request for the specific adjustment clause factors which shall, after hearing and
 3 Commission approval, become effective July 1, 2004.

4 Decision No. 61973 provided that: “[w]e concur that a PPA would result in less risk to the Company
 5 resulting in lower costs for the Standard Offer customers. As a result, we will approve the concept of
 6 the PPA as set forth in Section 2.6(1) with the understanding that the Commission can eliminate the
 7 PPA once the Commission has provided reasonable notice to the Company.” (Decision No. 61973 at
 8 page 12)

9 The proposed rate adjustment mechanisms include²:

- 10 1. a power supply adjuster (“PSA”) mechanism to recover the prudent and reasonable
 11 cost of providing power supplies for the Company’s Standard Offer and/or “provider
 12 of last resort” customers:
- 13 2. a returning customer direct assignment charge (“RCDAC”) to recover from direct
 14 access customers the additional costs, both one-time and recurring, that these
 15 customers would otherwise impose on other Standard Offer customers if and when the
 16 former return to Standard Offer service from their competitive suppliers;
- 17 3. a Systems Benefits adjustment clause (“SBAC”) rate mechanism that would permit the
 18 Commission to authorize the recovery of additional costs prudently and reasonably
 19 incurred by the Company for System Benefits programs authorized or required by the
 20 Commission under the provision of A.A.C. R14-2-1608; and
- 21 4. a Competition Rules compliance cost (“CRC”) rate adjustment mechanism that would
 22 permit APS to recover both the accumulated balance of prudent and reasonable costs
 23 (including return) incurred by the Company to comply with A.A.C. R14-2-1601, *et*
 24 *seq.* (“Electric Competition Rules”) and various Commission orders related to the
 25 implementation of such Electric Competition Rules.

26 Decision No. 56450 (April 13, 1989) ended APS’ Purchased Power and Fuel Adjustor
 27

28 ² As defined by the Company.

1 (PPFAC) and the Operating Incentive clause of APS.³ The Decision discussed the advantages and
2 disadvantages of the PPFAC, and concluded that fuel costs were stable and were expected to be
3 stable for the next few years; that the existence of the PPFAC causes piecemeal regulation which is
4 inefficient and undesirable; and that the disadvantages of the continuation of the fuel adjustor
5 outweigh any advantage.

6 In its testimony in this proceeding, Staff identified the following advantages and
7 disadvantages:

8 Advantages:

- 9 1. The reporting requirements and forecasts facilitate utility planning and Staff overview
10 of costs;
- 11 2. An adjustor that works correctly, over time, reduces the volatility of a utility's
12 earnings and the risk reduction can be reflected in the cost of equity capital in a rate case and
13 result in lower rates;
- 14 3. Adjustors can create price signals to consumers, but the effectiveness is reduced
15 considerably when a band is included and a twelve month rolling average is used;
- 16 4. Adjustors can help reduce the frequency of rate cases. But Staff notes that APS had
17 six rate cases in the ten years it had an adjustment clause before it was abolished, and only
18 one fully litigated rate case and three settlement agreements in the fourteen years since;
- 19 5. Regulatory lag between the incurrence of an expense and its recovery is reduced and
20 generational inequities are also reduced.

21 Disadvantages:

- 22 1. Adjustors can reduce incentives to minimize costs;
- 23 2. An adjustor that includes fuel or purchased power costs potentially biases capital
24 investment decisions towards those with lower capital costs and higher fuel costs;
- 25 3. Adjustors create another layer of regulation in addition to rate cases, increasing the
26 cost of regulation to the utility, its customers, and to the Commission;

27
28 ³ See Direct testimony of Staff witness Keene on the history of APS' adjustment clause, pp 3-4.

1 4. An adjustor can shift a disproportionate proportion of the risk of forced outages and
2 systems operations from shareholders to ratepayers;

3 5. Adjustors result in piecemeal regulation – an adjustor reflects an increase in one
4 expense but ignores offsetting savings in other costs;

5 6. Adjustors are complex and often difficult for analysts to read and interpret, and are
6 difficult to explain to customers;

7 7. Proper monitoring of adjustor filings and audits require the devotion of significant
8 Staff resources; and

9 8. Rates are less stable, resulting in rates changing frequently, making it difficult for
10 customers to plan energy consumption and the purchase of energy consuming appliances.

11 POWER SUPPLY ADJUSTOR (PSA)

12 Discussion

13 APS' application proposes a Standard Offer adjustment mechanism which it calls a Power
14 Supply Adjustor ("PSA"). The PSA is to be applied to Standard Offer customers to track the changes
15 in APS' cost of obtaining power supplies. APS proposes to include not only purchased power costs,
16 but fuel costs as well. The base power supply charge will be developed in the rate case, and then the
17 actual costs will be compared to that level. The PSA includes four components: a monthly Power
18 Cost Component Factor ("PCCF") charged to customers; a Balancing Account with a defined
19 maximum threshold amount of \$50,000,000 (approximately one month's fuel and purchased power
20 costs); a "band" that limits the amount of the PCCF that can be applied each time the PCCF is
21 changed; and an Amortization Charge to reduce the size of the Balancing Account.

22 The PCCF is calculated by comparing the rolling twelve-month average power supply cost for
23 fuel and power purchases to the base system average cost. The bandwidth is to be set each year in the
24 first six month adjustment period using 5 percent of the prior calendar year's Annual Retail Revenue
25 per kWh. The resulting bandwidth will be applied to the difference between the rolling twelve month
26 average power supply cost and the base system average cost at the six month adjustment cycles, and
27 will limit the increase or decrease in the PCCF. The Balancing Account serves two functions: it
28 accumulates dollars associated with under-collection or over-collection from the application of the

1 PCCF due to timing differences; and will accumulate credits or debits due to the band limits in the
2 PCCF calculation. When the Balancing Account reaches its threshold, APS proposes that the balance
3 will be zeroed out and an energy-based charge will be created to amortize the balance over a one year
4 period. The Balancing Account will accrue interest at the three-month commercial rate. APS
5 proposes to make semi-annual informational filings containing all calculations regarding the PSA and
6 including a revised tariff sheet with the new PCCF. Commission action would be required only when
7 APS files to establish or revise an Amortization Charge.

8 Staff testified that it saw no compelling reason to adopt the APS proposed adjustor and
9 surcharge mechanisms at this time, and believes that the pending APS rate case is a better forum for
10 constructing and implementing the mechanisms, so that their effect on customers can be determined.
11 Staff believes that APS' proposed mechanisms are not vital to its operations nor to its financial
12 health, and so are not necessary at this time. Staff believes that at the time the Commission approved
13 the Settlement Agreement, it expected that APS would be purchasing all of its power and that a
14 significant impact may occur to APS' financial well being without an adjustor. Since the
15 Commission's Decision No. 65154 (Track A) stopped APS' divestiture, that expectation has not
16 materialized. Staff believes that because Decision No. 61973 approved the "concept" of an adjustor,
17 rather than approving and implementing a specific adjustor, the "Commission has wide latitude to
18 develop an adjustment mechanism that suits the current facts and circumstances." Staff Initial Brief,
19 at 11-12.

20 Although Staff expressed reservations about the necessity for APS' proposed adjustor
21 mechanism, based on the provisions of the 1999 Settlement Agreement as well as its review of the
22 proposed PSA, Staff does not believe adoption of a PSA would harm the public interest, subject to
23 inclusion of the conditions described herein. Because Decision No. 61973 did not contemplate
24 recovery of fuel costs in the adjustor, Staff recommends that if an adjustor is approved, the
25 Commission should include fuel costs in the PSA in order to prevent APS from skewing its
26 procurement decisions. Staff states that an adjustment mechanism that does not include fuel may
27 encourage APS to purchase power rather than run its existing units, even though it may be cheaper to
28 run the existing units, and that it may cause APS to schedule unit maintenance without considering

1 the costs in the context of timing. According to Staff, the “danger is that the utility may base its
2 operational decisions upon ease of cost recovery rather than the underlying economics, thereby
3 resulting in higher costs to ratepayers.” Staff Initial Brief at 12.

4 Based upon its review of the provisions of the 1999 Settlement Agreement and the PSA, Staff
5 believes that the PSA, subject to the following conditions, would not harm the public interest:

- 6
- 7 1. The PSA should expire three years from its effective date, and nine
8 months prior to the expiration, APS could file for an extension and the
9 Commission could review the PSA mechanism;
- 10 2. The Commission should reserve the right to review the prudence of fuel
11 and power purchases at the time of the above review or at any time;
- 12 3. The Commission should reserve the right to review any calculations
13 associated with the PSA at any time;
- 14 4. There should be an earnings test attached to the PSA to prevent APS from
15 passing on rate increases if it is already earning an appropriate rate of return;
- 16 5. Any costs flowed through the PSA should be subject to refund if costs
17 were found later not to be prudently incurred;
- 18 6. The amortization period for an amortization charge should not be
19 determined at this time;
- 20 7. APS should file monthly reports to the Director of the Utilities Division;
- 21 8. APS should file additional monthly reports confidentially with Staff;
- 22 9. APS should keep all contracts and invoices for fuel and purchased power;
- 23 10. Reduction of risk should be considered in the cost of equity in APS’ next
24 rate case;
- 25 11. The bandwidth limit should be set at \$0.004 (4 mills) per kWh; and
- 26 12. The rate case decision should require APS to file a plan with Staff for
27 providing notice to customers about the PSA charge and any rate changes
28 resulting from the case.

20 Condition #1

21 APS opposes several of Staff’s conditions, including Condition #1 which requires the PSA to end
22 after three years unless APS takes action to request its continuance. APS believes that the Staff
23 recommendation provides no safeguards or guidelines on how due process requirements would be
24 met, or what would happen with existing bank balances and how to reintegrate the PCCF into the
25 base rates. APS believes that three years is not enough time to evaluate the PSA’s merits. In
26 response, Staff states that APS has not shown that the adjustment mechanisms are vital to its
27 operations or to its financial health and “has instead relied upon the simple fact that the Commission
28 has approved its settlement agreement, even though facts surrounding that approval are vastly

1 different from the facts today.” Staff Initial Brief at 3. Staff testified that it is very difficult to design
2 an adjustment mechanism correctly, and that circumstances change and modifications will be likely.

3 Conditions #2& 3

4 APS also opposes Condition #2’s provision that the Commission is not limited as to when it may
5 conduct a prudence review. APS argues that there should be a limit on how far back the Commission
6 can go and make retroactive adjustments and suggests six months. Staff believes that APS’ proposed
7 six month or one year limit on the Commission’s ability to review APS’ use and implementation of
8 the PSA puts ratepayers at risk.

9 Condition #4

10 APS opposes Staff’s Condition #4 which limits increases in fuel and purchased power costs by
11 application of an “earnings test.”

12 Staff recommends that the Commission adopt an earnings test to ensure that APS collects just and
13 reasonable rates. Staff believes that allowing APS to increase its PSA rates when it is earning over an
14 established benchmark return on equity would constitute a windfall gain at the expense of ratepayers.
15 Staff recommends that APS’ PSA be designed so that it cannot increase rates (base tariff plus the
16 PSA) if such an increase reflects over-earning. APS argues that the earnings test is not symmetrical,
17 but Staff responds that the asymmetry is intended as a “relief valve” to minimize the harm to
18 ratepayers, as APS would not voluntarily apply for a rate decrease when it is over earning, but would
19 apply for an increase when it is under earning. Staff testified that its “earnings test” is in response to
20 the Commission’s request of Staff to review the necessity and application of adjustment mechanisms,
21 and ways to improve them. Staff believes that its earnings test will significantly improve the
22 adjustment mechanism by helping to insure that APS does not reap windfall profits at the expense of
23 ratepayers.

24 APS argues that such an earnings test is unprecedented in this jurisdiction; would cause
25 significant accounting and financial reporting issues; would be cumbersome to implement; and is
26 unfair in its one-sidedness. In response, Staff states that just because the earnings test has not been
27 used previously is not a reason to reject it; that deferrals and disallowances are common regulatory
28 actions and no other jurisdiction has encountered such problems; the Commission only needs to adopt

1 the concept and the details can be worked out in the rate case; and the earnings test results in a more
2 fair PSA because if APS is earning a healthy return on equity for its shareholders, then it should not
3 pass on rate increases to its ratepayers. Staff presented an exhibit showing a graph depicting APS'
4 quarterly return on common equity from June 2000 to September 2002. (Exhibit S-6, JST-2) APS'
5 return peaked at 16.3 percent, and Staff questions a PSA that would allow rate increases while APS is
6 earning a 16.3 percent return. According to Staff, the PSA that APS proposes would pass along cost
7 increases, unchecked. Staff's earnings test concept is designed to put a check on adjustor increases.
8 Staff believes that an earnings test is critical in order to ensure just and reasonable rates.

9 APS argues that Staff's earnings test is unlawful under *Arizona Community Action Assoc. v.*
10 *Arizona Corporation Commission*, 123 Ariz. 228, 559 P.2d. 184 (1979) because it ties a rate
11 mechanism to the Company's earned return on common equity. According to APS, no other
12 jurisdiction uses the earnings test as proposed by Staff. APS believes that the earnings test would
13 "accentuate the very earnings instability the PSA is intended to ameliorate and may cause the very
14 'over earning' that Staff appears to fear." APS Initial Brief at 17. APS also argues that the earnings
15 test is impractical because it would force a "mini-rate case" every six months, thereby eliminating
16 one of the benefits of an adjustor.

17 APS believes that Staff's proposed earnings test is a violation of the APS Settlement
18 Agreement because it will not allow for the "full and timely recovery" of the reasonable and prudent
19 costs.

20 In response to APS' *Arizona Community Action* argument, Staff argues that the case actually
21 holds that the Commission may not base a rate increase solely on a single criterion that places
22 shareholders' interests above ratepayers' interests. Staff differentiates its earning test because it is
23 not a single tariffed rate; no recovery will be allowed unless the fuel and purchased power expenses
24 are reasonable and prudent; and because it is designed to protect ratepayers.

25 Condition #6

26 APS opposed Staff's Condition #6 which allows the Commission to determine the appropriate
27 amortization period on a case by case basis. APS argues that the Commission should establish a one-
28 year period for amortization, subject to the ability of APS or other parties to request a different time

1 period. Staff opposes a “one-size-fits-all” amortization time period. It believes that the size of the
2 amount to be amortized and other factors should be considered when determining an appropriate
3 amortization period. Establishing an amortization period without knowing or considering the
4 magnitude of the amount to be amortized may lead to significant rate increases. Staff recommends
5 that the Commission determine the amortization period on a case by case basis.

6 Other Conditions

7 Concerning Staff’s Condition # 10, which is that a reduction in risk should be considered in
8 the cost of equity in APS’ rate case, APS does not believe that there would be any such risk reduction
9 due to Staff’s three year automatic “sunset” of the PSA and the Staff recommended “earnings test”,
10 but does not disagree in principle that consideration of risks is appropriate in a rate proceeding.

11 Although APS proposed a percentage cap, it did not oppose Staff’s Condition #11’s 4
12 mill/kWh “bandwidth limit” because the two are roughly equivalent.

13 APS agreed with Staff Conditions #7, 8, and 12.

14 Fuel Costs in PSA

15 APS believes that an adjustor mechanism is appropriate for its purchased power and fuel costs
16 because they constitute an expense that is very large compared to its total operating costs, they are
17 very volatile, and very unpredictable. APS argues that “by 2004, the first year for which the PSA
18 would be effective, fuel and purchased power will account for 40% of APS operating costs. And gas
19 and purchased power, the two most volatile and unpredictable components of power supply costs,
20 will constitute 60% of total fuel and purchased power expense.” APS Initial Brief at 12. APS states
21 that the fuel used by virtually all new generation in the West is natural gas, and the Company’s
22 dependence on “these two volatile power supply elements (gas and purchased power) can only grow
23 in the years after 2004.” Id. at 13 APS believes that the inclusion of gas is “clearly justified given its
24 significance to overall utility costs now that Decision No. 65154 has halted divestiture, its volatility
25 (both presently and historically), and its interchangeability with purchased power in meeting the
26 power supply needs of Standard Offer customers.” Id. at 14.

27 APS recognizes that Decision No. 61973 and the Settlement Agreement do not specifically
28 mention fuel with reference to the PSA, but point out that the Settlement Agreement mentions “full

1 and timely” recovery of prudent and reasonable costs.

2 Although Staff agreed that gas prices are volatile and that natural gas now makes up a larger
3 percentage of APS’ fuel portfolio, Staff recommends that fuel be included in the PSA primarily
4 because Staff believes that it would prevent the Company’s operational decisions from being
5 inappropriately skewed.

6 RUCO Recommendation

7 RUCO recommends denying the PSA, arguing that although the Settlement Agreement
8 originally contemplated an adjustor mechanism for purchased power costs, it is no longer necessary
9 in light of the Commission’s Track A Decision. RUCO argues that a “primary purpose of the 1999
10 Settlement Agreement has been frustrated by the failure of the wholesale market to develop.” RUCO
11 Initial Brief at 9. RUCO also states that the Settlement Agreement’s adjustor mechanism did not
12 include fuel costs. Therefore, RUCO concludes that the Commission is not obligated to implement
13 the PSA. Because the costs that the PSA would recover are not volatile; because the impact of APS’
14 purchased power costs will be far less than what was contemplated under the Settlement Agreement;
15 because of the potential for piecemeal ratemaking; and because fuel costs do not meet the standard
16 for an automatic adjustment mechanism, RUCO believes the Commission should deny the PSA.

17 AECC Recommendation

18 AECC does not support the PSA proposed by APS. AECC believes that the Settlement
19 Agreement provided for a PSA allowing APS to recover only its purchased power costs. AECC’s
20 witness testified that the PSA was to be used to recover wholesale purchase power costs, not costs
21 associated with a vertically integrated utility. AECC believes that any adjustor approved in this order
22 should not include costs other than purchased power costs, and that fuel costs should be addressed in
23 APS’ pending rate case.

24 AECC argues that APS’ proposal to include fuel costs lacks important details regarding the
25 treatment of wholesale sales. According to AECC, the formula proposed by APS does not back out
26 the energy and fuel costs associated with wholesale transactions, and it does not properly separate
27 wholesale and retail transactions. AECC believes that this supports its recommendation not to
28 include fuel costs in a PSA at this time, but to consider it in the rate case. Additionally, AECC argues

1 that the Commission cannot establish an adjustor clause outside of a rate case in light of *US West*
2 *Communications Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242, 34 P.3d 351 (2001) and *Residential*
3 *Utility Consumer Office v. Arizona Corp Comm'n*, 199 Ariz. 588, 20 P.3d 1169 (App. 2001). The
4 AECC recommends that since the costs and charges to be included in the adjustment mechanism are
5 not to be determined until the rate case, the Commission should defer the adoption of the adjustment
6 mechanisms to the rate case, when all factors such as costs, allocation of costs, risk to the customer
7 and company, and the appropriate rate of return can be taken into consideration. The AECC
8 recommends that the rate case address maintaining incentives for fuel cost minimization, recognizing
9 a wholesale revenue credit, and ensuring that none of the costs associated with provision of Standard
10 Offer service before July 1, 2004 are rolled forward into the adjustor mechanism. AECC
11 recommends that the Commission approve any changes in the PSA rates, and that APS' PSA should
12 consider customer class differences in line losses and off-peak energy use, and apply an equal
13 percentage change on the generation cost component for each customer.

14 Analysis

15 Under traditional regulatory ratemaking, a utility has incentive to keep its expenses under
16 control, so that it has the opportunity to earn its authorized rate of return. Under some circumstances,
17 public utility commissions have departed from the traditional ratemaking methodology when
18 circumstances sufficiently warrant unusual treatment. One such treatment is the implementation of
19 adjustor mechanisms. This departure from traditional regulatory treatment is adopted usually for one
20 or more of the following reasons: the expense is outside the direct control of the utility; the expense
21 represents a large percentage of the utility's operating costs; and because the cost is volatile. The
22 purpose of the adjustor is to prevent this expense from adversely affecting the utility's financial
23 ability to provide adequate service to its customers.

24 Here, APS argues that its adjustors should be approved because the Commission adopted a
25 Settlement Agreement that provided for the adjustors. APS argues that even if the Settlement
26 Agreement did not explicitly include fuel costs, fuel cost should be included in the adjustor, because
27 its fuel costs are volatile and are an increasing portion of its overall expenses. Staff believes that APS
28 has not justified the need for adjustors, but recognizes that Decision No. 61973 adopted the concept

1 of a purchased power adjustor, and so recommended conditions that it believes would result in no
2 harm to the public interest.

3 We agree with Staff that Condition #1, which requires APS to request continuance of the PSA
4 prior to its otherwise automatic termination at three years, is reasonable. Although APS posed
5 potential procedural concerns, we believe that those can be addressed at the time a request for
6 extension is made. Staff has indicated that any procedure that will provide for a meaningful review
7 of the PSA would be acceptable to Staff. Additionally, at the time of the request for continuance,
8 there will be over two years of actual experience with the PSA which we believe is adequate time to
9 evaluate its merits.

10 We also agree with Staff that Condition #2 is appropriate. The use and implementation of the
11 PSA will create additional regulatory duties for Staff and will require significant review and audit
12 time. We do not think it is reasonable to limit our Staff's or our ability to insure that the rates passed
13 through the PSA are reasonable and appropriate. Any objections to "stale" data or evidence can be
14 made and considered in the context of the review. It is reasonable that in exchange for the ability to
15 quickly pass the costs through the PSA, that the review period of those costs not be limited.

16 Staff's Condition #6 is also reasonable. Setting an amortization period without knowing the
17 amount of dollars involved invites problems. Usually when setting an amortization charge, the
18 Commission considers not only the amount, but also the time period over which the amount
19 accumulated, and also perhaps the season during which it will be collected. Although a set one year
20 period may provide certainty to APS, it does not provide for the flexibility we need in order to insure
21 that the rates are reasonable and appropriate in a given case.

22 Condition #4 is the most controversial condition recommended by Staff. It is an earnings test
23 designed, essentially, to limit the adjustor's ability to pass along rate increases when the utility is
24 already earning a healthy rate of return. APS has stated that an earnings test "fundamentally alters
25 the earnings neutral nature of adjustment mechanisms in a manner that is not used for any other
26 utility in Arizona" (APS Exception pg. 2 lines 8-9 and see pg. 8 lines 13-15). Recently, this
27 Commission approved, in Docket No. W-01445A-00-0962, Decision No. 66400, an earnings test for
28 Arizona Water Company. Therefore, the implementation of this earnings test would not be

1 unprecedented. Staff notes that from June 2000 through September 2002, APS' quarterly return on
2 common equity peaked at 16.3 percent which exceeds APS' authorized rate of return. (Staff Post
3 Hearing Brief at 5.)

4 Staff Condition #4 is not adopted by this Order because it is more appropriate to review APS'
5 historical return on equity in the pending rate case. In that forum, the Commission can consider this
6 information when adjusting APS' rates to ensure that APS earns its established rate of return. This
7 may result in lower rates for APS customers on a going forward basis. The earnings test proposed by
8 Staff discourages efforts by APS to make sound investment decisions that maximize its return if that
9 investment would result in a return that is above an established benchmark. While APS' healthy
10 return on equity is noteworthy, it is appropriate for the Commission to consider this information in
11 APS' pending rate case, not in this matter.

12 The Commission disagrees with APS that imposing an earnings test on APS would raise
13 "serious questions of constitutional due process and equal protection" (APS Exception at 8). We find
14 that this test is not an option the Commission chooses to adopt at this time. For the reasons stated
15 above, this Order declines to adopt Staff Condition #4.

16 While the Commission rejects Staff Condition #4, it is appropriate for the parties in APS'
17 pending rate case to work on developing a symmetrical incentive or performance based rate ("PBR")
18 mechanism.

19 We believe that under Decision No. 61973, the Commission is not bound to approve a PSA as
20 presented by APS. Specifically, the Commission did not approve fuel to be included in the PPA. In
21 concept, an adjustor mechanism shifts risk from the utility. As Staff testified, an adjustor reduces
22 earnings volatility and reduces the lag time between incurring the expense and recovering its cost.
23 This risk reduction benefits the company and its shareholders. As APS testified, purchased power
24 and fuel costs comprise 40 percent of its costs. The adjustor shifts risk from the shareholder to the
25 ratepayer. Only 60 percent of costs would be placed in a fixed rate. The Commission recognizes that
26 it is in Arizona's interest to maintain a healthy economic environment for Arizona utilities. However,
27 passing through such a high percentage of APS' costs is too great a risk for the ratepayer to bear.

28 Staff favors including fuel costs in the adjustor. We are cognizant of the concern that without

1 the inclusion of fuel, a bias toward purchasing power develops even if it is not the most economical
2 option. However, we believe that Staff Conditions #2, #5, #7, #8 and #9 eliminate any incentive to
3 make imprudent purchased power decisions. APS must file monthly reports with Staff and keep all
4 contracts and invoices. The Commission may review the prudence of power purchases at any time.
5 If the Commission finds APS imprudently chose to purchase power rather than to run its own
6 generation, the Commission may order APS to refund these costs.

7 We believe the rate case should address issues raised by AECC concerning proper recognition
8 of a wholesale credit and how to ensure that none of the costs associated with the provision of
9 Standard Offer service before July 1, 2004 are rolled forward into the adjustor mechanism.

10 Furthermore, APS is placed on notice that the PSA may be eliminated during the pending
11 APS rate case.

12 On the issue of whether we can establish an adjustor outside of a rate case, the AECC
13 discussed two Arizona cases decided after we issued Decision No. 61973. According to the AECC,
14 *US West Communications Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242 requires a fair value
15 determination of a utility's property in connection with establishing rates, and *Residential Util.*
16 *Consumer Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 592 (App.2001) holds that "an adjustment
17 clause can be set 'only after a full rate hearing' 199 Ariz. at 592" AECC Initial Brief at 5. Staff
18 stated in its Initial Brief that although that case "would appear to hold that the Commission cannot
19 establish an adjustment mechanism outside of a rate case", it "does not address whether the
20 Commission could establish an adjustment mechanism in a proceeding that included a fair value
21 finding but was less than a full rate case. This is still an open question under Arizona law." Staff
22 Initial Brief at 9. Staff concludes that the issue of whether the Commission can create an adjustor
23 outside of a rate case is not presented in this proceeding, because the adjustor and surcharge
24 mechanisms will not take effect until the conclusion of the pending rate case. We agree that an
25 adjustor may be approved outside of a rate case. However, the adjustor and charges approved by this
26 Decision shall not go into effect unless affirmatively approved in the Order addressing APS' rate
27 case.

28 Arizona Constitution Article XV §3 requires the Commission to set just and reasonable rates.

1 To do so, the Commission, in most situations, must make a fair value finding. “The terms of an
2 adjustment clause are just as much a part of a tariff or rate schedule as are rates expressed in terms of
3 cents per kilowatt hour of electricity.” (Op.Atty.Gen. No. 71-15 at 9). The “Rio Verde” court found
4 that an automatic adjustment clause is a part of the utility’s overall rate structure which can be set
5 only after a finding of a fair valuation of all the utility’s assets. (RUCO v. Arizona Corporation
6 Commission, 199 Ariz. 558, 592 (2001)). The construction of adjustment mechanisms approved by
7 this Order directly impact the architecture of APS’ rates. The two are inextricably linked. While this
8 Order approves the concept of an adjustor, a Commission decision regarding a constructed, detailed
9 adjustor shall be decided as part of APS’ rate case.

10 Due process and compliance with A.R.S. §40-252 are met. In Arizona, monopoly is tolerated
11 only because it is subject to vigilant and continuous regulation by the Corporation Commission and is
12 subject to rescission, alteration or amendment at any time upon proper notice when the public interest
13 would be served by such action. (ACC v. Arizona Water Co., 111 Ariz. 74, 76 (1974)). APS is on
14 notice that the adjustor approved by this Order shall not go into effect without the express approval
15 by this Commission in APS’ pending rate case. In fact, as far back as the 1999 Order approving the
16 Settlement Agreement, APS was on notice that “we will approve the concept of the PPA as set forth
17 in Section 2.6(1) with the understanding that the Commission can eliminate the PPA once the
18 Commission has provided reasonable notice to the Company.” (Decision No. 61973 at 12). APS will
19 have another opportunity to be heard on this matter in the rate case.

20 **RETURNING CUSTOMER DIRECT ASSIGNMENT CHARGE (RCDAC)**

21 APS proposes an RCDAC that would collect from an individual or aggregate group of
22 customers who return(s) to APS Standard Offer service after having been served by a competitive
23 supplier. The RCDAC applies only to larger customers and would reflect the additional costs of
24 serving the returning customers.

25 Staff does not oppose the RCDAC with the following conditions:

- 26 1. The RCDAC tariff should specify that the charge will be applicable only to individual
27 customers or aggregated groups of customers of three MW or greater;
- 28 2. The RCDAC tariff should indicate that a customer will not be subject to the RCDAC

1 if he provides APS with one year's advance notice of his intent to take Standard Offer service;

2 3. APS should break down the individual components of the potential charges on the
3 RCDAC tariff, define them, and provide a general framework that describes the way in which
4 the RCDAC will be calculated;

5 4. APS should file a revised Schedule AP-2 for Staff review prior to its implementation;

6 5. The RCDAD and Schedule AP-2 should not be effective until the conclusion of APS'
7 upcoming rate case.

8 RUCO believes that it is appropriate for the Commission to approve a surcharge to recover
9 generation costs related to returning large customers and that the amount to be recovered and the
10 timeframe for recovery should be determined in the pending rate case. AECC did not oppose the
11 RCDAC.

12 APS did not agree that the tariff should include all costs that returning customers might face
13 because it believes that it is not practical or possible to identify all costs until the time when the
14 customer actually returns. APS does not agree with Staff that it should be precluded from seeking a
15 direct assignment of other costs to a returning customer under other circumstances on a case by case
16 basis. Staff argues that although the precise costs may not be determinable in advance, the types of
17 costs that may be incurred could be described, and tariffs should provide customers with reasonable
18 notice of its terms and not allow the utility to load on additional costs not clearly contained in its
19 tariffs. Staff recommended that APS be required to modify its RCDAC to reflect all possible costs of
20 returning to Standard Offer service and to prevent a RCDAC on customers who give at least one
21 year's notice of intent to return to Standard Offer service.

22 We believe that Staff's recommendation on the RCDAC is appropriate. Customers should
23 have notice of the types of costs that may be incurred, so that they can plan accordingly.

24 **SYSTEMS BENEFITS ADJUSTMENT CHARGE (SBAC)**

25 APS proposed a "placeholder" SBAC that allows it to pass through a charge to cover costs of
26 any future Commission-approved System Benefit programs that are not included in the Company's
27 base rates. Staff believes that it is premature to authorize approval of a surcharge mechanism to
28 recover costs of programs that have not been developed. In response to APS' argument that the

1 SBAC was mandated by Decision No. 61973 and the Settlement Agreement, Staff argues that it was
2 anticipated that APS would have proposed actual tariffs or programs in conjunction with the
3 mechanism, and that absent such specific proposals or plan of administration, there is nothing to
4 evaluate. Staff believes that because any Commission order evaluating future programs would
5 contain all the necessary authorizations for rate recovery and would determine how the new System
6 Benefits costs would be collected, the SBAC serves no present purpose. Staff further notes that APS
7 cannot bypass the fair value requirement of the Constitution by establishing a “placeholder”
8 surcharge mechanism – if and when the Commission authorizes new System Benefit rates, the fair
9 value requirement must be satisfied.

10 RUCO believes that it is appropriate for the Commission to approve a surcharge to recover
11 System Benefits costs and that the amount to be recovered and the timeframe for recovery should be
12 determined in the pending rate case. The AECC did not oppose the SBAC.

13 Although the Settlement Agreement provided for an SBAC, APS did not file a plan of
14 administration or propose any programs or tariffs. However, we do not see any harm in creating an
15 SBAC at this time, as any recovery under this surcharge will only be allowed after we have reviewed
16 and approved the program, determined how the new System Benefits charge would be collected, and
17 after satisfying the fair value requirement. Accordingly, we will approve the SBAC with the
18 understanding that the above items will be complied with prior to any collections.

19 COMPETITION RULES COMPLIANCE COST (CRC)

20 The CRC is a means for APS to recover its costs associated with its transition to competition
21 and includes costs incurred from 1999 through 2004 to comply with the Commission’s Electric
22 Competition Rules. APS proposes that the total amount to be recovered would be determined in the
23 rate case and recovered through an amortization charge over the next five years.

24 Staff recommended that the review of the CRC be included in the pending rate case because it
25 is difficult to determine the proper amortization period without knowing the size of the amount to be
26 recovered. Accordingly, Staff recommends that the Commission consider the design and other
27 aspects of the CRC in the pending rate case.

28 RUCO believes that it is appropriate for the Commission to approve a surcharge to recover

1 costs incurred to transition to competition and that the amount to be recovered and the timeframe for
2 recovery should be determined in the pending rate case.

3 The AECC did not oppose the CRC, but disagrees with including Regional Transmission
4 Organization (“RTO”) related costs in the adjustor, stating that APS should seek approval from
5 FERC for recovery of these costs in transmission rates. APS states that there is no need to determine
6 now what costs will be recovered through the CRC mechanism, but APS does believe that RTO
7 formation is “within the scope of costs that the Commission indicated in the APS Settlement would
8 be recovered in the CRC mechanism” APS Initial Brief at 8.

9 We agree with Staff that the review of the CRC should occur in the rate case, as the
10 appropriate level of costs to be recovered will be determined there. The issue of inclusion of RTO
11 costs should also be addressed then. We are adopting a CRC at this time, but the specifics of the
12 surcharge will be determined later, during the pending rate case where they can be evaluated in
13 context of the size of the amount to be recovered.

14 * * * * *

15 Having considered the entire record herein and being fully advised in the premises, the
16 Commission finds, concludes, and orders that:

17 **FINDINGS OF FACT**

18 1. APS is a public service corporation engaged in furnishing electricity in the State of
19 Arizona. APS provides either retail or wholesale electric service to substantially all of Arizona, with
20 the major exception of the Tucson metropolitan area and about one-half of the Phoenix metropolitan
21 area. APS also generates, sells and delivers electricity to wholesale customers in the western United
22 States.

23 2. On May 31, 2002, APS filed an Application for Approval of Rate Adjustment
24 Mechanism.

25 3. Notice of the application was provided in accordance with the law.

26 4. Intervention was granted to RUCO, AECC, and Panda.

27 5. The hearing was held on April 7 and 8, 2003. Briefs were filed on May 2 and 15,
28 2003.

1 6. In Decision No. 61973 (October 6, 1999), the Commission adopted the APS
2 Settlement Agreement as modified.

3 7. The Settlement Agreement stated that the Commission would approve adjustor
4 mechanisms for recovery of four categories of costs.

5 8. Decision No. 61973 provided that: “[w]e concur that a PPA would result in less risk to
6 the Company resulting in lower costs for the Standard Offer customers. As a result, we will approve
7 the concept of the PPA as set forth in Section 2.6(1) with the understanding that the Commission can
8 eliminate the PPA once the Commission has provided reasonable notice to the Company.”

9 9. APS’ requested rate adjustor mechanisms include a PSA, an RCDAC, an SBAC, and a
10 CRC.

11 10. There are both advantages and disadvantages of implementing purchased power/fuel
12 adjustor mechanisms.

13 11. Although Staff testified that APS’ proposed adjustor mechanisms are not vital to APS
14 operations or to its financial health, Staff recommended that approval of a PSA that includes fuel
15 costs and also includes 12 conditions would not harm the public interest.

16 12. The PSA presented by APS is not the PPA “concept” that the Commission approved
17 in Decision No. 61973.

18 13. According to Staff, if fuel costs are not included in the PSA, the utility may base its
19 operational decisions upon ease of cost recovery rather than the underlying economics, and thereby
20 increase costs to ratepayers.

21 14. Staff Condition #4 is rejected.

22 15. The PSA adopted herein includes purchased power costs and does not include the cost
23 of fuel, including the purchase of fuel for tolling agreements.

24 16. AECC’s recommendations concerning proper recognition of a wholesale credit, and
25 how to insure none of the costs associated with provision of Standard Offer service before July 1,
26 2004 are rolled forward into the adjustor mechanism, are reasonable and should be adopted.

27 17. Except for Condition #4, Staff’s conditions to the PSA, as discussed herein, are
28 reasonable and should be adopted.

1 18. The RCDAC with the conditions proposed by Staff should be adopted.

2 19. The SBAC proposed by APS, and as to be developed and modified by in the pending
3 rate case and in subsequent Commission decisions, should be approved.

4 20. The CRC should be adopted but the design and other aspects will be determined
5 during the pending rate case where they can be evaluated in context of the size of the amount to be
6 recovered.

7 21. The requested rate adjustor mechanisms shall become effective upon the affirmative
8 approval of these mechanisms in the Order addressing the APS rate case, Docket No. E-01345A-03-
9 0437.

10 **CONCLUSIONS OF LAW**

11 1. Arizona Public Service Company is a public service corporation within the meaning of
12 Article XV, Section 2 of the Arizona Constitution.

13 2. The Commission has jurisdiction over APS and of the subject matter of the instant
14 proceeding.

15 3. The adjustment mechanisms/surcharges should be approved with the modifications
16 made herein.

17 4. APS' PSA proposal in this docket is not the PPA concept approved in Decision No.
18 61973.

19 5. APS is given notice pursuant to Decision No. 61973 and A.R.S. § 40-252 that the
20 adjustment mechanisms approved herein may be modified or eliminated in the pending rate case.
21 The mechanisms shall not go into effect without the Commission's express approval in the rate case.

22 6. It is just and reasonable that the adjustor mechanisms/surcharges approved herein may
23 be modified in APS' rate case and will become effective upon the Commission's decision in that
24 docket.

25 **ORDER**

26 IT IS THEREFORE ORDERED that the concept of a Purchased Power Adjustor, as modified
27 herein is approved.

28 IT IS FURTHER ORDERED that Arizona Public Service Company's request for a Returning

1 Customer Direct Assignment Charge, as modified herein, is approved.

2 IT IS FURTHER ORDERED that Arizona Public Service Company's request for a System
3 Benefits Charge mechanism, as modified herein and in any subsequent Commission decision
4 approving a system benefit to be recovered through such mechanism, is approved.

5 IT IS FURTHER ORDERED that Arizona Public Service Company's request for a
6 Competition Rules Compliance Charge, as to be determined in the pending rate case, is approved.

7 IT IS FURTHER ORDERED that the adjustment mechanisms/surcharges approved herein
8 and as subsequently modified, will become effective upon the conclusion of Arizona Public Service
9 Company's pending rate case.

10 IT IS FURTHER ORDERED that Arizona Public Service Company shall comply with all the
11 conditions as adopted herein.

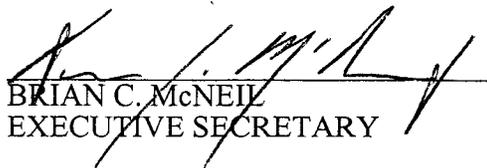
12 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

13 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

14
15   
16 CHAIRMAN COMMISSIONER COMMISSIONER

17  
18 COMMISSIONER COMMISSIONER

19 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
20 Secretary of the Arizona Corporation Commission, have
21 hereunto set my hand and caused the official seal of the
22 Commission to be affixed at the Capitol, in the City of Phoenix,
23 this 18th day of November, 2003.

24 
BRIAN C. McNEIL
EXECUTIVE SECRETARY

25 DISSENT _____

26 DISSENT _____

27 LAF:dap

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