

**MEMORANDUM**

TO: Docket Control

FROM: Ernest G. Johnson  
Director  
Utilities Division

DATE: September 27, 2004

RE: STAFF REPORT ON ADJUSTMENT MECHANISMS CONTAINED IN THE  
PROPOSED SETTLEMENT AGREEMENT OF ARIZONA PUBLIC SERVICE  
COMPANY'S REQUEST FOR RATE ADJUSTMENT (DOCKET NO. E-01345A-  
03-0437)

Attached is the Staff Report on Adjustment Mechanisms contained in the proposed settlement agreement of Arizona Public Service Company's request for rate adjustment. Staff recommends approval of the settlement agreement.

EGJ:RGG/BEK:rdp

Originator: Robert Gray and Barbara Keene

Attachment: Original and thirteen copies

Service List for: Arizona Public Service Company  
Docket No. E-01345A-03-0437)

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**STAFF REPORT  
UTILITIES DIVISION  
ARIZONA CORPORATION COMMISSION**

**ARIZONA PUBLIC SERVICE COMPANY**

**DOCKET NO. E-01345A-03-0437**

**ADJUSTMENT MECHANISMS  
CONTAINED IN THE PROPOSED SETTLEMENT AGREEMENT**

**SEPTEMBER 2004**

## **STAFF ACKNOWLEDGMENT**

The Staff Report on Adjustment Mechanisms Contained in the Proposed Settlement Agreement of Arizona Public Service Company's Request for Rate Adjustment, Docket No. E-01345A-03-0437, was the responsibility of the Staff members listed below.

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**TABLE OF CONTENTS**

	<b><u>PAGE</u></b>
<b>INTRODUCTION.....</b>	<b>1</b>
<b>POWER SUPPLY ADJUSTOR .....</b>	<b>1</b>
<b>COMPETITIVE RULES COMPLIANCE CHARGE.....</b>	<b>3</b>
<b>RETURNING CUSTOMER DIRECT ACCESS CHARGE.....</b>	<b>3</b>
<b>TRANSMISSION COST ADJUSTOR.....</b>	<b>3</b>

## **Introduction**

The proposed settlement agreement in the Arizona Public Service (“APS”) rate proceeding (Docket No. E-01345A-03-0437) contains provisions for implementing various adjustment mechanisms. These include the Power Supply Adjustor (“PSA”), the Demand Side Management (“DSM”) Adjustor, the Environmental Portfolio Standard (“EPS”) Adjustor, the Competitive Rules Compliance Charge (“CRCC”), the Returning Customer Direct Access Charge (“RCDAC”), and the Transmission Cost Adjustor (“TCA”). The DSM Adjustor and EPS Adjustor are discussed in the Staff Report on Demand-side Management, Renewables, and Distributed Generation.

The structure and features of the adjustors discussed in this report are the result of settlement negotiations on a wide variety of issues in this case. Staff believes that the PSA, through a variety of provisions, reasonably balances the interests of ratepayers and APS while providing a measure of both certainty and flexibility in the future treatment of the PSA. As part of the overall settlement agreement, the adjustor mechanisms are in the public interest.

## **Power Supply Adjustor**

APS does not currently have a PSA, so there is no provision for variation in fuel and purchased power costs between rate cases. The proposed PSA provides for the tracking of changes in purchased power and fuel costs. Initially, the adjustor rate would be set at zero. The adjustor rate would be reset annually beginning with the first April billing cycle each year, starting in 2006. Each year, APS would file a publicly available report by March 1<sup>st</sup>, documenting how the new adjustor rate was calculated. The Commission and other interested parties would have the opportunity to review the calculation of the new adjustor rate before it is applied to customer bills. The base cost of fuel and purchased power would be set at \$0.020743 per kWh, to be included in APS’ base rates.

The entirety of each year’s over or under collection would be subject to a sharing mechanism where APS receives a 10 percent share and ratepayers receive a 90 percent share, the net effect of which is that APS would be at risk for 10 percent of each year’s under recovery and would receive the benefit of 10 percent of each year’s over recovery. This sharing mechanism provides APS with an incentive to reduce the cost of its purchased power and fuel at all times and allows ratepayers to share in those savings.

A bandwidth of \$0.004 per kWh would limit the amount the adjustor rate could change from one year to the next. This bandwidth would limit the amount of annual rate change APS customers would see from fuel and purchased power costs, absent specific Commission action. Any remaining over or under collection would be carried over in a balancing account, the contents of which would not be subject to the 90/10 sharing provision in future years. The balancing account would accrue interest based on the one-year nominal Treasury constant maturities rate. Accrual of interest could benefit APS or APS ratepayers, depending on whether the balancing account is over or under-collected.

When the balancing account reaches either a positive or negative \$50 million level, APS would have 45 days to file for Commission approval of a surcharge/credit to address the under/over recovery. If APS does not wish to address this balance, it must file a report explaining why action is not necessary. Commission action would be required to establish or change a surcharge created pursuant to this provision. The Commission and its Staff may review the prudence of fuel and purchased power costs and the adjustor calculations at any time. Any costs flowed through the adjustor are subject to refund if they are later found by the Commission to be imprudent.

The life of the PSA would be at least five years from the date the rates resulting from this proceeding go into effect. Within four years of the date the PSA is implemented, APS would file a report, with supporting testimony, regarding its experience with the PSA and recommending whether the PSA should remain in effect. The Commission would consider continuation of the PSA after APS has filed this report, or during its next rate case, whichever comes first. Whether in a future APS rate case or in a review of APS' PSA report, any action to abolish the PSA would not take effect until the five-year period had expired. If the Commission decides to retain the PSA such that it extends beyond the initial five-year period, the Commission may later abolish the PSA at any time, including outside a rate proceeding, subject to the applicable procedural requirements. If the Commission abolishes the PSA, the Commission would address any existing under/over recovery existing at the time of termination. The Commission may also adjust APS' base rates to reflect the costs of fuel and purchased power. These provisions provide the Commission with flexibility in considering whether the PSA should be continued in the future and, if so, in what form.

The settlement agreement requires APS to file on-going monthly reports of PSA-related activity. One report, publicly available, would be provided to Staff and the Residential Utility Consumer Office and would include bank balance calculations, power and fuel costs, customer sales, customer numbers, items excluded from the PSA calculations, adjustments to the PSA calculations, off-system sales margins, system losses, monthly maximum retail demand, and a contact person. A second, confidential, report would be provided to Staff, with detailed information on generating units, power purchases, and fuel purchases. Both reports would be due on the first day of the third month after the end of the month which the report covers. An APS officer would certify under oath that the information contained in the public and confidential reports is true and accurate to the best of her or his information and belief. Additionally, APS would provide the information to be contained in these reports for the base cost of fuel and purchased power costs during the test year, as included in the settlement. These reporting requirements will provide the Commission with a variety of on-going information for use in monitoring APS' purchased power and fuel procurement activities and other matters.

Other provisions of the PSA include ratepayers retaining the benefits of all APS off-system sales, subject to the 90/10 sharing provision and the \$0.004 bandwidth provision. Such off-system sales benefits will reduce the overall cost of fuel and purchased power for ratepayers. The PSA would also allow for recovery of the prudent direct costs of hedging contracts for fuel

and purchased power, providing APS with flexibility in hedging its fuel and purchased power costs. The PSA would not apply to direct access customers or customers served under Rates E-36, SP-1, Solar-1, and Solar-2. As part of APS' tariff compliance filing, the Company would file a plan of administration, detailing how the PSA would operate.

### **Competitive Rules Compliance Charge**

The CRCC is a charge which would enable APS to recover costs related to the transition to retail competition. The settlement agreement includes approximately \$8 million in the test year for this charge, and APS may recover a maximum of \$47.7 million plus interest through a charge of \$0.000338 per kWh over a five-year collection period. The CRCC would terminate immediately once this amount is recovered. If a balance remains at the end of the five-year period, APS would file an application with the Commission to adjust the CRCC to recover the remaining balance.

The CRCC would be a separate surcharge, i.e., it would not be included in base rates. All customers would pay the CRCC, except for those served on rate schedules Solar-1 or Solar-2. As part of APS' tariff compliance filing, the Company would file a plan of administration, detailing how the CRCC would operate.

### **Returning Customer Direct Access Charge**

The RCDAC would apply to customers who return to standard offer service from direct access service and would be calculated separately for each customer. The RCDAC would address the additional one-time and recurring costs incurred by APS to provide standard offer service to returning customers, which otherwise would be imposed on other standard offer customers. The RCDAC would apply only to customers or aggregated groups with a load of 3 MW or greater and only if the customer or group does not provide APS with a one-year notice of intent to take standard offer service. The RCDAC rate schedule would identify and define the components of the charge as well as a general framework of how the charge would be calculated. The RCDAC would not last longer than 12 months for any individual customer. As part of APS' tariff compliance filing, the Company would file a plan of administration, detailing how the RCDAC would operate.

### **Transmission Cost Adjustor**

The TCA is an adjustor which would be established to ensure that standard offer customers and direct access customers pay the same transmission costs. The TCA would apply only to costs related to changes in APS' open access transmission tariff ("OATT") or the tariff of a regional transmission organization ("RTO") or similar organization. The TCA would not go into effect until APS' transmission component of retail rates exceeds the test year base of \$0.000476 per kWh by five percent. APS may then file with the Commission for approval of a TCA rate. When APS files with FERC to change its transmission rates, it would file a notice of such application with the Commission and provide a copy of the application to the Director of

the Utilities Division. As part of APS' tariff compliance filing, the Company would file a plan of administration, detailing how the TCA would operate.

### **Staff Position**

The implementation of an adjustor mechanism such as the PSA entails a wide range of considerations which must be weighed carefully to ensure that such a mechanism is in the public interest. Adjustor mechanisms by their nature attempt to balance a variety of possible goals, such as certainty, flexibility, price stability, sending a price signal as prices change, and providing a reasonable opportunity to recover prudently incurred costs. The PSA contained in the proposed settlement agreement contains a variety of provisions which addresses both the interests of ratepayers and APS in a reasonable fashion. While no adjustor mechanism can fully protect ratepayers from the underlying volatility of energy markets, the proposed PSA helps shield ratepayers from price volatility through the provision of regular adjustments of the adjustor rate, the inclusion of a bandwidth limiting the amount of automatic adjustment in the adjustor rate, and the provision of the opportunity for cost recovery of the costs of hedging fuel and purchased power costs. Further, APS is motivated to minimize the cost of fuel and purchased power through the 90/10 sharing mechanism.

The five year life of the PSA and related provisions protect the public interest by providing the opportunity to review the PSA mechanism in the future for possible modification or termination while also providing APS with a level of certainty regarding the method of cost recovery for its substantial fuel and purchased power costs. Such flexibility is important given the new nature of the proposed PSA and the uncertainty regarding what future conditions will be in the electricity industry.

The settlement contains strong safeguards which enable the Commission to review costs which APS would be passing through to its customers via the PSA. The settlement provides a commitment by APS to provide a wide variety of information related to the operation of the PSA on a monthly basis, which will assist the Commission and other interested parties in monitoring and assessing the operation of the PSA. Additionally, the settlement agreement specifically recognizes that the Commission can review the prudence of fuel and purchased power costs at any time. In summary, Staff believes the adjustor provisions contained in the proposed settlement agreement are in the public interest, as they reasonably balance the interests of ratepayers and APS and provide a variety of incentives to the Company to manage the PSA in a manner which is beneficial to its ratepayers while also providing the opportunity to address any problems which may arise in the future operations of the PSA.