

**MEMORANDUM**

TO: Docket Control

FROM: Ernest G. Johnson  
Director  
Utilities Division

DATE: September 27, 2004

RE: STAFF REPORT ON THE TREATMENT OF COMPETITIVE ISSUES AND CERTAIN PINNACLE WEST ENERGY CORPORATION'S ASSETS 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 the Treatment of Competitive Issues and Certain Pinnacle West Energy Corporation's ("PWEC") Assets Contained in the Proposed Settlement Agreement of Arizona Public Service Company's Request for Rate Adjustment. Staff recommends approval of the settlement agreement.

EGJ:MJR:rdp

Originator: Matthew Rowell

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**

**TREATMENT OF COMPETITIVE ISSUES AND CERTAIN PWEC ASSETS  
CONTAINED IN THE PROPOSED SETTLEMENT AGREEMENT**

**SEPTEMBER 27, 2004**

## **STAFF ACKNOWLEDGMENT**

The Staff Report on the Treatment of Competitive Issues and Certain PWEC Assets 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.

Matthew Rowell  
Chief Economist

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## Introduction

On August 18, 2004, a proposed Settlement Agreement of Arizona Public Service Company's ("APS") pending rate case was docketed. That agreement contained proposed resolutions of issues regarding the treatment of Pinnacle West Energy Corporation's ("PWEC") Arizona generation assets. The agreement also contains several provisions that are pertinent to competition in the wholesale and retail electric markets in Arizona. The purpose of this Staff Report is to explain the provisions of the Settlement Agreement that deal with the PWEC assets and competitive issues.

## PWEC Asset Treatment

Section II of the Settlement Agreement deals with the treatment of certain PWEC assets. The parties to the Settlement Agreement agreed that APS should be allowed to acquire and rate base the following PWEC generating units: West Phoenix CC-4, West Phoenix CC-5, Saguaro CT-3, Redhawk CC-1, and Redhawk CC-2 (collectively, the "PWEC Assets"). The capacity of each of these generating units is displayed in the following table:

| Unit              | Capacity in MW |
|-------------------|----------------|
| West Phoenix CC-4 | 120            |
| West Phoenix CC-5 | 500            |
| Saguaro CT-3      | 100            |
| Redhawk CC-1      | 530            |
| Redhawk CC-2      | 530            |

The Track B competitive solicitation resulted in a contract between APS and PWEC for the purchase of a significant portion of this capacity during the summer months of 2003 through 2006. The rate basing of the above generating units will make this contract unnecessary. In order to recognize the ratepayer benefits associated with that contract, a portion of the value of the PWEC assets will be disallowed. Specifically, \$148 million of the PWEC Assets' value will be disallowed, which results in an original cost rate base value of \$700 million as of December 31, 2004.

APS has agreed that it will never seek recovery of "stranded costs" associated with any of the PWEC Assets.

FERC approval is necessary to transfer the PWEC Assets to APS. APS shall file a request for FERC approval within thirty days of the Commission approving the Settlement Agreement. Upon Commission approval of the Settlement Agreement, APS' rates will reflect the rate basing of the PWEC Assets. However, APS cannot actually acquire the PWEC Assets until FERC approval of the transfer is obtained. To bridge the time between the effective date of the rate increase and the actual date of the asset transfer, APS and PWEC will execute a cost-based purchased power agreement ("Bridge

PPA”). The Bridge PPA will be designed to represent the (non-fuel) costs of the PWEC Assets recovered in base rates per the Settlement Agreement. During the term of the Bridge PPA, APS will flow fuel costs (and off-system sales revenue) related to the PWEC Assets through the power supply adjustor (“PSA”). Any demand and non-fuel energy charges incurred under this Bridge PPA will be excluded from recovery under the PSA because they are already included in APS’ base rates. The Bridge PPA shall remain in effect until FERC issues a final order approving the transfer of the PWEC assets to APS and the transfer is completed.

The parties believed it was appropriate to include provisions in the Agreement that deal with the possibility of FERC issuing an order that is in some way inconsistent with the Settlement Agreement. If FERC issues an order denying APS’ request to transfer the PWEC Assets, the Agreement provides for the Bridge PPA to become a thirty-year PPA. Prices in this thirty-year PPA will reflect cost-of-service as if APS had acquired and rate-based the PWEC Assets at the value established in the Settlement Agreement. If FERC issues an order approving APS’ request to acquire the PWEC Assets but at a value materially less than \$700 million, or if FERC issues an order approving the transfer of fewer than all of the PWEC Assets, or if FERC issues an order that is materially inconsistent with the Settlement Agreement, APS shall promptly file an appropriate application with the Commission so that rates may be adjusted. In these circumstances, the Bridge PPA shall continue at least until the conclusion of this subsequent proceeding to consider any appropriate adjustment to APS’ rates.

The Commission Decision in APS’ last financing case (Decision No. 65796) established a basis point credit that is to be paid by PWEC to APS. That basis point credit established in Decision No. 65796 will continue as long as the associated debt between APS and PWEC is outstanding. Credit for amounts deferred after December 31, 2004 shall be reflected in APS’ next general rate proceeding.

The Parties agreed that West Phoenix CC-4 and West Phoenix CC-5 are “local generation” as that term is defined in the AISA protocol or any successor FERC-approved protocol. During must-run conditions, generation from the West Phoenix facility will be available at FERC-approved cost-of-service prices to electric service providers serving direct access load in the Phoenix load pocket.

### **\$234 Million Write-Off**

Per Section VI of the Settlement Agreement, APS has agreed that it will not recover (now or in any subsequent proceeding) the \$234 million write-off attributable to Decision No. 61973, the Commission order that approved the 1999 APS Settlement Agreement.

### **Competitive Procurement of Power**

Section IX of the Settlement Agreement includes provisions intended to enhance the prospects of the wholesale market in Arizona while still protecting retail customers. APS agrees that it will not pursue any self-build option having an in-service date prior to January 1, 2015, unless expressly authorized by the Commission. This provision does not prevent APS from purchasing a generation plant from a merchant or a utility. It also does not prevent APS from acquiring temporary generation needed for system reliability, distributed generation of less than fifty MW per location, and renewable resources. The up rating of APS generation is also allowed under this provision (not including the installation of new units.)

The Settlement Agreement does not relieve APS of its existing obligation to prudently acquire generating resources. If APS determines it is unable to fulfill that obligation without pursuing a self build option, APS will file an application with the Commission seeking authorization to self-build a generating resource(s).

Any application by APS for Commission authorization to self-build generation prior to 2015 will at a minimum address:

- a. APS' specific unmet needs for additional long-term resources.
- b. APS' efforts to secure adequate and reasonably priced long-term resources from the competitive wholesale market.
- c. The reasons why APS believes those efforts have been unsuccessful, either in whole or in part.
- d. The extent to which the self-build application is consistent with APS' resource plans and competitive resource acquisition rules or orders that may result from the Commission's resource planning workshops.
- e. Life cycle costs of the self-build option compared to that of available options available from the wholesale market.

The Settlement Agreement does not preclude APS from negotiating bilateral agreements with nonaffiliated parties.

APS will issue an RFP or other competitive solicitation(s) no later than the end of 2005 seeking long-term future resources of not less than 1000 MW for 2007 and beyond.

- a. "Long-term" resources means any acquisition of a generating facility or an interest in a generating facility, or any PPA having a term, including any extensions exercisable by APS on a unilateral basis, of five years or longer.
- b. Neither PWEC nor any other APS affiliate will participate in the 2005 solicitation.
- c. Regarding RFPs and solicitations after 2005, neither PWEC nor any other APS affiliate will participate without the appointment by the Commission or its Staff of an independent monitor.
- d. APS will not be obliged to accept any specific bid or combination of bids.
- e. All renewable resources, distributed generation, and DSM will be invited to

compete in the 2005 RFP or other competitive solicitation and will be evaluated in a consistent manner with all other bids, including their life-cycle costs compared to alternatives of comparable duration and quality.

The Commission Staff has agreed to schedule workshops on resource planning issues that focus on developing needed infrastructure and developing a flexible, timely, and fair competitive procurement process. These workshops will also consider whether and to what extent the competitive procurement should include an appropriate consideration of a diverse portfolio of short, medium, and long-term purchased power, utility-owned generation, renewables, DSM, and distributed generation. The workshops will be open to all stakeholders and to the public. If necessary, the workshops may be followed with a rulemaking proceeding.

The Settlement Agreement allows APS to continue to use its Secondary Procurement Protocol except as modified by the express terms of this Agreement or unless the Commission authorizes otherwise.

### **Regulatory Issues**

Section X of the Settlement Agreement contains provisions regarding certain regulatory issues. The Parties agreed that APS has the obligation to plan for and serve all customers in its certificated service area, irrespective of size. However, APS is to recognize, in its planning, the existence of any Commission direct access program and the potential for future direct access customers. These provisions do not prevent any Party from seeking to amend APS' obligation to serve at some time in the future.

The parties agreed that any changes in retail access will be addressed through the Electric Competition Advisory Group ("ECAG") or other similar process. One particular issue that will be addressed by the ECAG (or similar proceeding) is the resale by Affected Utilities of Revenue Cycle Services ("RCSs") to Electric Service Providers ("ESPs").

The Parties agreed that APS currently has the ability to self-build or buy new generation assets for native load, subject to the conditions in Section IX and X of the Settlement Agreement.

The Parties agreed that APS should be able to join a FERC-approved Regional Transmission Organization ("RTO") or an organization(s) performing the functions of an RTO. If the Settlement Agreement is approved, APS may participate in such organizations without further order or authorization from the Commission. The Agreement does not establish the ratemaking treatment for costs related to participation in an RTO.

The Settlement Agreement does not create or confirm an exclusive right for APS

to provide electric service within its certificated area, diminish any of APS' rights to serve customers within its certificated area, or prevent the Commission or any other governmental entity from amending the laws and regulations relative to public service corporations.

### **Staff's Position**

While Staff was unpersuaded by the company's original argument for inclusion of the PWEC assets in rate base, Staff believes that the Settlement Agreement as a whole provides for a reasonable treatment of those assets. The Settlement Agreement as a whole mitigates the impact on rate payers associated with rate basing the PWEC assets and balances the potentially anti-competitive effects of rate basing with the pro-competitive provisions discussed above. The rate payer impact is mitigated because the assets are being added to the rate base at a value substantially less than their book value. Also, because the settlement provides for APS to drop its pending Track A related lawsuits against the Commission, rate payers will not face the risk of having to fund a \$234 million (or more) judgment in APS' favor. The Settlement Agreement provides for substantial commitments by APS to market based approaches to filling future capacity needs. The self build moratorium and RFP commitments outlined in Section IX of the Agreement will bolster the competitive alternatives available to APS. Taken as a whole Staff believes the Settlement Agreement strikes an appropriate balance between market and non-market approaches.