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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

- MARC SPITZER, Chairman
- WILLIAM A. MUNDELL
- JEFF HATCH-MILLER
- MIKE GLEASON
- KRISTIN K. MAYES

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN TEHREON, TO APROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND FOR APPROVAL OF PURCHASED POWER CONTRACT.

Docket No. E-01345A-03-0437

NOTICE OF FILING RESPONSES TO COMMISSIONER INQUIRIES

Commission Staff hereby gives Notice of Filing Responses to Commissioner Inquiries in connection with the Settlement discussions in this docket. These Responses were compiled by Staff and represent the collective positions of the participants in Settlement negotiations.

RESPECTFULLY SUBMITTED this 18th day of August, 2004.

Arizona Corporation Commission

DOCKETED

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**RESPONSES TO COMMISSIONER
ISSUES IN CONNECTION WITH
PROPOSED SETTLEMENT
OF
DOCKET NO. E-01345-03-0437,
ARIZONA PUBLIC
SERVICE COMPANY
REQUEST FOR
RATE ADJUSTMENT**

The Commissioners have identified issues for the Parties to consider in settlement discussions. This memorandum addresses those issues. Each of the commissioners' questions are summarized below.

I. Commissioner Mundell's May 6, 2004 Memorandum

A. Bill Estimation Procedures

In Docket No. E-01345A-03-0775, APS has asked the Commission to address its bill estimation procedures. Since this rate case will determine what rates APS' customers will be paying, please discuss as part of this rate case how those same customers' bills may and/or can be estimated.

While Staff recognizes the importance of this issue, Staff believes that the public interest will be best served by a comprehensive analysis, instead of an analysis that is focused solely upon APS. With that end in mind, the Process Standardization Working Group ("PSWG") is in the process of developing a statewide standard for electric utility bill estimation procedures. The PSWG was founded in 1999 after the Commission's enactment of the retail electric competition rules. Its members include representatives from APS, TEP, SRP, and the cooperatives. The PSWG develops methods for standardizing utility systems in order to facilitate coordination among utilities during and after the transition to competition. Because the PSWG routinely develops standards for utility operations, Staff believes that the PSWG will be able to provide some useful information on this issue. The PSWG anticipates completing this project by the end of this calendar year.

In addition, Staff is also analyzing APS' bill estimation procedures independently of the PSWG's efforts. Staff's review is ongoing. In light of these ongoing efforts, the proposed settlement agreement does not address this issue. Staff will file a report in docket No. E-01345A-03-0437 (the APS rate case docket) for the Commission's review before the commencement of the hearing on the Proposed Settlement.

B. Changes in Break-Over Points for Tiered or Seasonal Rates

APS currently has tiered rates (i.e., the more you use, the more you pay) for several of its customer classes. Please discuss the break-over points for these tiers and consider whether they should be modified based on more current usage data and conservation goals. The parties should explain why there should be or should not be any modifications to these break-over points.

In general, break-over points, which are also referred to as "rate blocks," are established to reach a pricing goal, such as tracking marginal cost, or a social goal, such as conservation or customer equity. Reducing or shifting rate blocks can cause unintended rate impacts for existing customers. For example, a change in break-over points coupled with a rate increase could result in some customers receiving a rate increase that substantially exceeds the system average. In order to avoid these types of

results, the Parties have been cautious about changing the break-over points for APS' rates.

APS currently has approximately five residential and nine general service or miscellaneous tariffs that feature tiered or seasonal rates. A list of these specific rates and the number of customers subscribing to each follows:

Rate Schedule	Description	Number of Customers (2003 Avg.)
Residential		
E-10	Seasonal/Tiered (Frozen)	90,880
E-12	Seasonal/Tiered	383,661
EC-1	Seasonal (Frozen)	24,002
ECT-1R	Seasonal/TOU	43,557
ET-1	Seasonal/TOU	286,266
General Service		
E-21	Seasonal/TOU (Frozen)	27
E-22	Seasonal/TOU	18
E-23	Seasonal/TOU	146
E-24	Seasonal/TOU	48
E-30	Seasonal	4,530
E-32	Seasonal/Tiered	95,388
E-20	Seasonal/TOU	339
E-38	Seasonal/Tiered/TOU Option	152
E-221	Tiered/TOU Option	1,384

Regarding residential rates, the Agreement provides for the current rate structure and break-over points to remain in place. On APS' most common residential rate, E-12, the first break point occurs at the first 400 kWh, the second break point occurs at the second 400 kWh; and the third applies to all additional usage above 800 kWh.

Based on test year usage data for the test year summer months (May – October), approximately 32% of E-12 bills fall in the first block (first 400 kWh), and 30% fall in the second block (second 400 kWh). The average E-12 customer with a consumption of 770 kWh per month will be billed on the second block. Above average use customers (usage above 800 kWh) account for 38% of customer bills. This structure provides a lower rate for customers with a lower than average usage and a higher rate for customers with a higher than average usage. The Parties believe that this rate structure encourages conservation.

As to APS' general service rates, the predominant schedule with breakpoint and seasonality features is E-32. The E-32 rate, which applies to general service customers with demand less than three MW, accounts for ninety-four percent of APS' general

service customers and is responsible for eighty-one percent of current general service revenue. The current rate includes a relatively complex series of declining blocks and block expanders, which can be confusing to customers, and has both a demand charge and four energy blocks.

The settlement agreement proposes a number of changes to E-32. First, the Settlement rates simplify the rate by reducing the number of energy blocks to two, with two demand blocks for customers with loads over twenty kW. Staff and APS believe that a simpler, more understandable rate will allow customers to better manage their electric usage. Second, the Settlement rates incorporate higher demand charges, which will encourage customers to manage their monthly peak load. Third, the rate will include a 100 kW billing break point in the demand portion of the rate to provide for smoother rate transitions as customers' loads change over time. In addition, the Settlement rates block the energy billing elements of the rate based on the customer's load factor, which will encourage more efficient utilization of the utility's investment in generation, transmission, and distribution systems. Finally, Paragraph 57 of the Settlement Agreement requires APS to conduct a study analyzing rate design modifications to encourage energy efficiency, discourage wasteful and uneconomic use of energy, and reduce peak demand.

C. Discounts for Automatic Customer Payments

Please discuss why APS does not offer a discount to its customers for automatic payment of their bills. Please discuss the possibility of including this type of discount in APS' tariffs as part of this rate case.

In Decision No. 61976, the Commission gave APS authority to provide for a one-time payment of \$10.00 to customers choosing automatic payment. Commissioner Mundell correctly notes that APS' tariffs do not otherwise provide for discounts for customers who choose automatic payment.

Although APS has not elected to provide the one-time discount at this time, 12.6 percent of APS' residential customers, 8.5 percent of its general service customers, and 12.1 percent of all APS customers participate in Surepay, its automatic payment plan. According to APS, E-Source/Platts, an independent energy industry information service, reports that national participation rates in such programs average nine percent for residential customers and four percent for non-residential customers. APS also points to a 2003 report by Chartwell, an information technology management consulting firm, that estimates national participation in such programs to average between eight and twelve percent. These statistics suggest that APS' customer participation levels for its automatic payment program are at least comparable to national levels even in the absence of an ongoing discount.

At present, APS believes that discounts would be uneconomic. A discount might increase customer participation in the automatic payment program. APS believes, however, that any increase in cash flow and minor reduction in bill processing expenses

resulting from such increased customer participation would be more than offset by the discount. In other words, the potential cost savings from increased customer participation would not cover the costs of ongoing discounts. As a result, customers who elect to forego the automatic payment option would end up paying for the ongoing discount enjoyed by those who choose automatic payment.

At this time, the Parties do not propose to require changes to the discounts for customers electing automatic payment.

D. School District Issue

At a public comment session, many school district representatives spoke of the hardship of incorporating any rate increase into their already approved budgets. Please discuss the possibility of phasing in any rate increase that would apply to school districts. The thought behind this request is to allow the school districts time to get any Commission approved rate increase incorporated into their budgets.

At the April 7, 2004 public comment session, several school districts stated that an increase in electric rates would be burdensome, especially because the state legislature was considering eliminating "excess utilities" funding. A.R.S. § 15-910 provides that excess utilities costs are exempt from a school district's revenue control limit for budgeting until at least the end of the 2008-09 budget year. Senate bill 1405 (46th Leg., 2d Sess. 2004) originally proposed to continue a cap on excess utilities funding that was enacted in prior legislation. This provision of S.B. 1405 was stripped out in a house floor amendment (Amendment No. 4570). As a result, the final version of the bill does not contain a cap on excess utilities funding. Accordingly, the excess utilities funding provided in A.R.S. § 15-910 will be available through the 2008-09 budget year.

Although the settlement agreement does not propose to phase in rates applicable to school districts, it does include several provisions that will benefit both schools and other general service customers. First, the agreement proposes a rate increase that is substantially lower than that originally proposed by APS. Second, the agreement's proposed changes to Rate E-32 will tend to reduce the rate impacts to lower load factor E-32 customers, such as schools. Finally, the Agreement proposes to substantially increase DSM funding, which will provide further opportunities for school districts to manage their electric utility costs. Specifically, the Preliminary Energy Efficiency Plan, Appendix "B" to the Agreement, includes the development of energy efficient schools, retrofitting schools, and financial incentives for schools to make energy efficient investments. Some school organizations joined AECC during the course of the Settlement negotiations. AECC actively participated in the negotiations.

II. Commissioner Gleason's May 10, 2004 Letter

A. Wholesale and Retail Competition

What principles should the parties include in any settlement that would promote wholesale and retail electric competition and would provide APS customers with a meaningful choice of suppliers of competitive services?

The settlement agreement provides a number of provisions that are designed to promote both wholesale and retail competition.

1. Section IX of the Agreement sets forth detailed provisions to encourage the development of the wholesale market:

a. The settlement agreement provides for restrictions on APS' ability to self-build new, large central station generation with an in-service date before 2015, subject to a safety mechanism that permits APS to seek an exemption from the Commission if the wholesale market cannot cost effectively meet the needs of APS' customers.

b. APS has also committed to issuing a broad "all sources" RFP no later than the end of 2005 seeking at least 1,000 MW of long-term resources from the market. Neither PWEC nor any other APS affiliate will participate in that procurement.

c. The Agreement also provides for Commission workshops on resource planning. These workshops will focus on both infrastructure development and wholesale competitive procurement.

2. Several provisions of the Agreement are designed to foster retail competition:

a. The Agreement prohibits APS from requesting recovery of stranded costs that may be associated with the acquisition and rate basing of assets presently owned by Pinnacle West Energy Corporation ("PWEC").

b. APS has also agreed to recognize the existence of any Commission-approved direct access programs in its resource planning process.

c. The rate design for general service customers, who are the customers most likely to seek direct access, establishes charges for competitive services, such as generation, billing, metering, and meter reading, at cost of service. Specifically, the revenue requirement resulting from the Agreement, other than those associated with the Competition Rules Compliance Charge ("CRCC") or System Benefits Charge, shall be first applied to generation charges to bring them to full cost of service and then next applied to revenue cycle services to bring them to cost of service. Setting rates for these potentially competitive services to better reflect cost is intended to create opportunities for competitors. After generation and revenue cycle services have been appropriately

priced, the residual general service revenue requirement will be assigned to wires services.

d. The Agreement provides that West Phoenix CC-4 and West Phoenix CC-5 shall be deemed local generation. During must-run conditions, generation from those units shall be available at FERC-regulated cost of service prices to electric service providers serving direct access load in the Phoenix load pocket.

e. The Agreement also provides for the Electric Competition Advisory Group ("ECAG") or similar stakeholder process to consider other retail competition issues on an industry-wide basis.

B. Shopping Credits

How should the APS "shopping credit" for competitive services such as generation and metering be recalculated to better promote electric competition? Please address an alternative method for calculation of the "shopping credit" for generation and other competitive services as compared to the method approved in Decision No. 61973 approving the APS stranded cost settlement.

The Agreement's proposed rate design regarding the calculation of the "shopping credit" is addressed in part 2.c of the previous answer. The Parties believe that this rate design appropriately addresses these issues at this time. In addition, the competition transition charge ("CTC") for customers choosing direct access will terminate on December 31, 2004. The elimination of the CTC effectively increases the "shopping credit," thereby raising the "price to beat" and creating opportunities for competitors.

C. Ring Fencing

What structural and legal "ring fencing" mechanisms should the Commission consider to maintain APS' separate corporate identity? Would additional oversight of affiliated transactions, dividend policies, securities issuances, ownership changes, diversification investments, and asset transfers be in the public interest?

APS believes that existing Commission rules and decisions suitably address the specific issues raised in this question, given the overall structure of the settlement agreement. These include the Commission's code of conduct; the various APS financing orders issued in 1984, 1986, and 2003, which limit APS' issuance of debt and other financing activities; the secondary procurement protocols in Track B, which address ongoing wholesale power procurement; and the Commission's existing affiliated interest rules, A.A.C. R14-2-801, et seq., which address affiliated transactions, securities issuances, diversification investments, and asset transfers.

By contrast, Staff believes that additional Commission oversight of APS' affiliated interests may be appropriate. In the Track A decision, the Commission

concluded that the existing codes of conduct need additional provisions in order to cover APS and all affiliates in energy-related fields, including affiliates that sell power. Decision No. 65154 at 25. In Decision No. 65434, the Commission indicated that it was concerned about the lack of “regulatory insulation” between APS and its affiliates. In Decision No. 65796, APS’ most recent financing case, the Commission required APS to maintain a minimum common equity ratio of forty percent as a condition of approving the application. Ultimately, some of these issues will be addressed in APS’ code of conduct proceeding, Docket No. E-00000A-02-0051, et. al., which is scheduled to resume at the conclusion of this proceeding.

Although the Agreement does not purport to comprehensively resolve these issues, it does contain several related provisions that address them:

1. The competitive procurement provisions in Section IX require an independent monitor for any competitive procurement process that involves an APS affiliate.
2. The Agreement also provides for an initial Request for Proposals (“RFP”) for at least 1,000 MW in which APS affiliates will not participate.
3. The self-build restrictions in Section IX provide for additional Commission oversight of future APS construction of new generation.
4. The Agreement provides for the continuation of APS’ Secondary Procurement Protocol

III. Chairman Spitzer’s May 14, 2004 Letter

A. Demand Side Management

Please consider the subject of demand side management/energy efficiency.

Section VII of the settlement agreement contains a comprehensive energy-efficiency demand side management (“DSM”) initiative. The Agreement includes the following features: \$10 million for energy-efficiency DSM in base rates, Commission oversight and pre-approval of energy-efficiency DSM programs, an adjustment mechanism to fund at least \$6 million annually for such programs above the base-rate amount, systematic reporting of DSM results, and a Preliminary DSM Plan for 2005 (Appendix B). The Agreement also provides for the creation of a collaborative working group to assist in implementation of DSM. Additionally, the competitive procurement provisions in Section IX specifically refer to DSM as a resource that is eligible to participate in the 1,000 MW RFP. In this competitive procurement, DSM bids will be evaluated consistently with other bids, including life-cycle costs.

B. Wind Energy

Please consider whether wind energy could be a component of purchased power contracts to serve load.

The Settlement Agreement expressly recognizes that the costs of wind energy (and other renewable resources that are near market price) may be recovered through the Power Supply Adjustor ("PSA"). Section VIII of the Settlement Agreement addresses the mechanics of cost recovery of such renewable resources through the PSA, which under the Settlement Agreement would be acquired through a separate RFP for at least 100 MW of renewable resources in 2005. It also includes a commitment by APS to seek ten percent of its incremental capacity needs from renewable resources. In addition, the 1,000 MW RFP in Section IX is open to renewable resources.

IV. Commissioner Hatch Miller's May 14, 2004 Memo

A. Enhancing Residential Time-of-Use Rates

Please examine the possibility of enhancing APS' time of use ("TOU") programs for residential customers.

In the settlement agreement, the Parties have included an experimental TOU program to allow up to ten thousand residential customers to choose a TOU rate with an alternative TOU period. For example, the experimental program will offer participating customers the option of selecting among two alternative on-peak periods, 7:00 a.m. to 7:00 p.m. or 8:00 a.m. to 8:00 p.m., instead of the standard on-peak period of 9:00 a.m. to 9:00 p.m. A pilot program is necessary to test both customer reaction to the program and to assess the administrative burden on APS, as APS has indicated that reprogramming meters for these experimental programs will be costly and time consuming. The Parties have not proposed additional TOU pilot programs at this time.

Approximately thirty-nine percent of APS' residential customers are on TOU rates, as compared with approximately twenty percent of SRP's residential customers and approximately three percent of TEP's customers. These numbers indicate that APS already has extensive customer participation in its TOU rates.

In addition to the expansion of its residential TOU program, the Parties are proposing a general service TOU rate to provide additional options to APS' general service TOU customers. This option will be open to any qualifying general service customer. Paragraph 57 of the Agreement also requires APS to conduct a study analyzing rate design modifications that could encourage energy efficiency, discourage wasteful and uneconomic use of energy, and reduce peak demand.

B. Changing Off- and On-Peak Hours

Please consider changing the timeframes of “off-peak” and “on-peak” hours, extending the duration of “off peak” hours, and including weekday holidays in the off-peak hours’ designation.

In its direct testimony, APS proposed significant changes to Rates ET-1 and ECT-1R, its TOU rates for residential customers. Specifically, APS proposed eliminating the on-peak/off-peak distinction during the winter months and charging a flat rate, which would be calculated by averaging the existing on-peak and off-peak rates. This change would have eliminated the off-peak/on-peak customer price signals during the winter months.

In developing its testimony, Staff concluded that it was opposed to APS’ proposal. Although APS’ winter peak is not as dramatic as its summer peak, the Company nonetheless experiences peak periods of use in the winter months. Staff concluded that, instead of eliminating the off-peak/on-peak distinction in the winter months, it would be better to simply change the off-peak and on-peak periods to better correspond to the Company’s actual winter peak. Staff also believes that APS should classify weekday holidays as off-peak periods.

APS, however, has identified significant meter reprogramming costs associated with implementing this change. APS claims that it cannot reprogram its meters in the field, but must instead remove them, reprogram them in its shops, and then reinstall them. As a result, APS estimates that including weekday holidays in the off-peak designation would take eighteen to twenty-four months and cost over \$30 million.

Staff believes that APS should develop metering systems that will allow it to be more flexible in designing its TOU rates. As a result, the Parties have agreed that APS shall conduct a study to determine how to resolve these meter programming issues so that APS can better accommodate its customers when designing its TOU rates. The study analyzing possible rate design modifications provided by Paragraph 57 of the Agreement, and referenced above in Section IV.A. will provide additional impetus to this effort.

C. Eliminating or Reducing Residential Demand Charges

Please consider eliminating or reducing any demand charges imposed on residential customers.

Only two of APS’ five residential rates, optional ECT-1R and EC-1, include a demand charge. APS believes that it is important to have an optional demand rate that accurately reflects cost causation to provide an appropriate price signal to residential customers.

Eliminating demand charges may adversely affect customers who have invested in demand control or have altered their lifestyles to take advantage of a rate schedule with

a demand component. These rate schedules are voluntary, so customers who prefer to avoid demand charges may elect an energy-only rate schedule. The Parties have not proposed to eliminate residential demand charges at this time.