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MEMORANDUM

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FROM: Ernest G. Johnson, Esq.
for Director
Utilities Division

2002 MAR -8 A 9:19
AZ CORP COMMISSION
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DATE: March 8, 2002

RE: STAFF REPORT FOR THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AN ORDER APPROVING A NEW FIXED INCOME MANAGER FOR THE PALO VERDE NUCLEAR GENERATING STATION DECOMMISSIONING TRUST FUNDS (DOCKET NO. E-01345A-02-0125)

Attached is the Staff Report for the application of Arizona Public Service Company for an order approving a new fixed income manager for the Palo Verde Nuclear Generating Station decommissioning trust funds. Staff recommends approval.

EGJ:JMR:rdp

Originator: Joel M. Reiker

Attachement: Original and eleven copies

Arizona Corporation Commission
DOCKETED

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Service List for: Arizona Public Service Company
Docket No. E-01345A-02-0125

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-02-0125

APPLICATION
FOR AN ORDER APPROVING A NEW FIXED
INCOME MANAGER FOR THE PALO VERDE
NUCLEAR GENERATING STATION
DECOMMISSIONING TRUST FUNDS

MARCH 2002

STAFF ACKNOWLEDGEMENT

The analysis contained in the Staff Report for the application of Arizona Public Service Company for approval of a new fixed income manager for the Palo Verde Nuclear Generating Station decommissioning trust funds, Docket No. E-01345A-02-0125 was conducted by Joel M. Reiker.

A handwritten signature in black ink, appearing to read "Jm Reiker", with a large, sweeping flourish at the end.

Joel M. Reiker
Senior Analyst

EXECUTIVE SUMMARY
ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. E-01345A-02-0125

On February 15, 2002, Arizona Public Service Company ("APS" or "Company") filed an application with the Arizona Corporation Commission requesting approval of NISA Investment Advisors ("NISA") to act as a new nuclear decommissioning trust fund fixed-income manager to succeed RCM Capital Management ("RCM"). Alternatively, and if the Commission is unable to act upon the Company's request for approval of a new nuclear decommissioning trust fund fixed-income manager prior to March 31, 2002, APS requests an interim order authorizing the other Commission-approved fixed-income manager, Delaware Investment Advisors ("DIA"), to manage both of the Company's fixed-income decommissioning trust funds pending Commission approval of a successor to RCM.

The reason APS is requesting approval of a new nuclear decommissioning trust fund fixed-income manager is because RCM was recently acquired by a French company, Allianz. Allianz already has a subsidiary engaged in fixed-income fund management, PIMCO. Allianz has decided that it does not want two subsidiaries competing with each other in the same basic line of business. Therefore, RCM's fixed-income business is being terminated.

Staff recommends approval of the Company's request to have NISA Investment Advisors succeed RCM Capital Management as a nuclear decommissioning trust fund fixed-income manager.

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Introduction

On February 15, 2002, Arizona Public Service Company ("APS" or "Company") filed an application with the Arizona Corporation Commission ("Commission") requesting approval of a new nuclear decommissioning trust fund fixed-income manager to succeed RCM Capital Management ("RCM"). Alternatively, and if the Commission is unable to act upon the Company's request for approval of a new nuclear decommissioning trust fund fixed-income manager prior to March 31, 2002, APS requests an interim order authorizing the other Commission-approved fixed-income manager, Delaware Investment Advisors ("DIA"), to manage both of the Company's fixed-income decommissioning trust funds pending Commission approval of a successor to RCM.

On March 1, 2001, APS filed an amendment to its application indicating that after careful consideration of several fund managers, it had chosen NISA Investment Advisors ("NISA") to succeed RCM. Therefore, APS requests that the Commission approve NISA as its new nuclear decommissioning trust fund fixed income fund manager prior to March 31, 2002, or grant interim authority to DIA to manage both of the Company's fixed-income decommissioning trust funds pending Commission approval of a successor to RCM.

In the event that the relief sought by the Company is not received prior to March 31, 2002, APS will be in non-compliance with prior Commission orders related to the Palo Verde Nuclear Generating Station ("Palo Verde") decommissioning trust fund.

Background

APS is a 29.1 percent part owner of Palo Verde. Other owner participants include Salt River Project, Southern California Edison, El Paso Electric Company, Public Service Company of New Mexico, and the Los Angeles Department of Water and Power. Palo Verde is licensed to operate by the Nuclear Regulatory Commission ("NRC") pursuant to 42 U.S.C. § 2011, *et seq.* Like all nuclear power plants, Palo Verde will eventually need to be decommissioned – an expensive and time consuming process. Because APS owns a 29.1 percent share of Palo Verde, it is responsible for funding 29.1 percent of decommissioning costs. Regulatory agencies throughout the country, including the Commission, have required that the cost of this eventual decommissioning be recovered from electric customers during the operating life of the facility.

Amounts collected from ratepayers during the life of a nuclear generating plant can either be administratively segregated by the collecting utility into a so-called "internal" decommissioning fund, or placed into a separate external entity (usually a trust) not controlled by the utility. The NRC and most state regulators prefer the external funding option, both because of the increased security of the funding for its intended

purpose and because of significant income tax benefits available to external funds meeting certain Internal Revenue Service ("IRS") qualifications, hence the term "qualified fund."

Each owner participant has its own decommissioning fund, which it funds to its individual ownership percentage. The total cost to decommission Palo Verde, in 1998 dollars, is expected to be \$1.8 billion. The total cost to APS, in 1998 dollars, is expected to be \$516 million.¹

APS was first ordered by the Commission to establish an external "qualified" nuclear decommissioning trust fund in Decision No. 55931, dated April 1, 1988. While changes and/or transactions related to the trust do not necessarily fall under the provisions of Arizona Revised Statutes or Commission rules, Decision No. 55931 established the Commission's control over certain parameters of the trust, including approval of the trustee, the various fund managers, and the categories of and limits to permissible classes of investments for the trust. To enable the trust's qualification under IRS regulations, which in turn affords the trust favorable tax treatment (thus permitting the fund to grow at a significantly lower cost to ratepayers),² the Commission also had to specifically apportion the total amount of APS' annual contribution (that was reflected in APS' retail rates) to each of the three Palo Verde Units.

The first fixed-income fund manager, RCM, was approved in Decision No. 56384, dated March 9, 1989. When RCM reached its original \$50 million dollar limit, the Commission authorized an equity fund manager, Mellon Capital Management ("MCM"), and, later, a second fixed-income manager, DIA, to manage additional contributions. The present trustee for all three investment funds, Mellon Bank, was approved in Decision No. 57426, dated June 19, 1991.

Decision No. 60098, dated March 19, 1997, increased the equity-funding limit from \$50 million to \$150 million. Both fixed-income funds remained capped at the \$50 million contribution limit each.³ These caps were consistent with the overall 60/40 equity/debt investment goal also established by the Commission in Decision No. 60098.⁴

Decision No. 64393, dated January 31, 2002, further increased the equity-funding limit from \$150 million to \$200, and authorized APS to invest a portion of the equity

¹ According to TLG Services, Inc., which performs a Decommissioning Cost Study every three years. The next Decommissioning Cost Study is due in December 2001.

² IRC § 468A provides that contributions to a qualified nuclear decommissioning trust are deductible in the year made to the extent these amounts are actually collected from ratepayers as part of cost-of-service. Furthermore, the income earned by the trust is taxed at a reduced rate of 20%.

³ APS refers to these limits as "contribution limits" because in each instance, the Company is permitted to place additional monies into the fund until it reaches the prescribed limit. Thereafter, APS cannot contribute additional amounts, but the fund can continue to accumulate earnings in excess of the "cap."

⁴ The Commission established this ratio after reviewing the decommissioning funding practices of 18 similar electric utilities, as well as the funding practices used by APS and others for pension and other long-term investments.

allowance in an equity fund tracking the Wilshire 4500 index. Decision No. 64393 also increased the contribution limits on both fixed-income funds from \$50 million each to \$75 million each. The following table more clearly illustrates the composition of the trust fund as currently approved by the Commission:

Table 1

Type of Fund	Fund Name	Current Contribution Limit	Percent of Total⁵
Fixed Income Funds	DIA	\$75	43%
	RCM	\$75	
Equity Funds	MCM	\$200	57%
	Total	\$350	100%

Reason for the Company's Request

RCM was recently acquired by a French company, Allianz. Allianz already has a subsidiary company engaged in fixed-income fund management, PIMCO. Allianz has decided that it does not want two subsidiaries competing with each other in the same basic line of business. Therefore, RCM's fixed-income business is being terminated. RCM has asked that its existing accounts be assigned to PIMCO. PIMCO has an extensive background in managing fixed-income funds for pension and benefit programs, but far less experience in handling nuclear decommissioning funds. PIMCO has also not been approved by the Commission. For these reasons, APS believed it would be prudent to evaluate other prominent fixed-income decommissioning fund managers as compared to PIMCO and then seek either Commission approval of PIMCO or approval for a replacement fund manager for RCM.

The Selection Process

Upon receiving notification on January 31, 2002, that RCM would be going out of the fixed-income fund management business within sixty days, APS immediately issued an electronic request for proposal ("RFP") to ten of the largest and most experienced decommissioning trust fixed-income fund managers (excluding the other current Palo Verde decommissioning fund managers) to evaluate against PIMCO. Seven of the ten non-PIMCO fund managers responded favorably to the RFP. The other three firms voluntarily dropped out of contention. From the remaining seven contenders, APS picked two finalists; Duff & Phelps Investment Management Co. ("D&P"), and NISA. These two finalists and PIMCO, then made individual in-person presentations to an APS

⁵ Decision No. 64393 decreased the equity component of the trust fund from 60% to 57%. Staff believes that a gradual reduction in the trust fund's equity ratio is appropriate in order to reduce the trust fund's exposure to higher-risk equity investment as the commencement of actual decommissioning nears.

selection committee composed of representatives from the APS finance, tax and accounting departments.

On February 28, 2002, APS informed Staff that it had selected NISA as the Company's new fixed-income decommissioning fund manager. According to the Company, the selection of NISA as the replacement fixed-income fund manager was based primarily on three fundamental criteria:

1. Experience in nuclear decommissioning fixed-income investment as measured both by the amount of decommissioning trust fund dollars under management and the number of individual nuclear utility clients.
2. Specialized tax expertise in this unique area of tax law so as to optimize after-tax returns to the fund.
3. Knowledge of all ongoing decommissioning legislation, tax regulations, etc.

Of the three finalists, NISA had the longest fixed-income decommissioning track record (14 years), the most fixed-income decommissioning funds under management (\$2.8 billion) and the largest number of fixed-income decommissioning fund clients (16). In contrast, D&P had 11 years of experience, a little under \$1 billion in fixed-income decommissioning funds under management, and nine fixed-income decommissioning fund clients. Finally, PIMCO has managed fixed-income decommissioning funds for less than a year, manages \$0.3 billion in fixed-income decommissioning funds, and currently has two fixed-income decommissioning fund clients.

NISA's non-nuclear fixed-income expertise goes back to 1975, and it is a 100% employee-owned firm, making a future takeover of the business less likely.

According to APS, NISA's tax optimization strategies were the best and most detailed of the three firms, and it spanned decommissioning accounts spread over many different states, each with its unique income tax provisions. Each individual trade or transaction entered into by NISA on behalf of the funds under its management is analyzed for optimum after-tax return.

Staff Recommendation

Staff reviewed the proposals and presentation materials of PIMCO, D&P, and NISA. Additionally, Staff contacted the Director of Taxable Client Services of NISA to confirm data and obtain audited financial statements. After reviewing all of the information provided by APS and the various fund managers, the Company's request appears to be reasonable and Staff recommends approval.

Staff recommends approval of the Company's request to have NISA Investment Advisors succeed RCM Capital Management as a nuclear decommissioning trust fund fixed-income manager.