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**SALT RIVER PROJECT**

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Manager, Regulatory Affairs & Contracts

November 8, 2006

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Chairman Jeff Hatch-Miller  
Commissioner William A. Mundell  
Commissioner Mike Gleason  
Commissioner Kristin Mayes  
Commissioner Barry Wong  
Arizona Corporation Commission  
1200 West Washington  
Phoenix, Arizona 85007

Arizona Corporation Commission  
**DOCKETED**

NOV 20 2006

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Subject: Information on SRP's Rate Stabilization Fund

Dear Commissioners:

Commissioner Mayes recently requested that SRP provide some additional information regarding its Rate Stabilization Fund.

The attached white paper includes an overview of SRP's Rate Stabilization Fund, a survey of Rate Stabilization Funds in the public power utility industry and an explanation of how the fund is incorporated into SRP's pricing philosophy.

We trust that you will find this information responsive to your request.

Sincerely,

Kelly J. Barr

Enc.

/seb

cc: Ernest Johnson  
Bill Post, APS

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## I. Introduction

This memo sets forth information on the Salt River Project's Rate Stabilization Fund (RSF). In 1999, SRP implemented a plan to enhance its financial flexibility in anticipation of changes to the electric utility industry that were contemplated from retail access, market driven generation, and competitive service provision of billing, meter reading, and metering. SRP undertook a series of financial transactions from 2001 to 2003 that restructured its existing debt to ensure that resources and assets acquired by that debt could be effectively used in a competitive environment.

This restructuring (also referred to as recapitalization) permitted SRP to modernize its Master Bond Resolution that had been in place since 1972, and permitted changes that adopted the flexibility and adaptability found in new indenture resolutions. The new Master Bond Resolution provided for the creation of a Rate Stabilization Fund (RSF).

RSFs are not new to the utility industry. There are many public power utilities that have or had implemented RSFs or some variation of them in their service territory. The mechanisms for funding a RSF can vary by utility. Some methods are formula driven; some utilities have specific price components in their tariffs; while others are funded through the discretionary actions of their Board or City Council.

RSFs are generally used to stabilize electric prices during changes to standard electric price plans or tariffs. The SRP Board has elected to apply the balances in the RSF to its Fuel and Purchased Power Adjustment Mechanism (FPPAM), usually referred to as a fuel escalator) to share favorable results with its customers in a more immediate and timely manner. The FPPAM is reviewed seasonally by the Board; although the Board has discretion to consider longer periods in setting the appropriate changes to stabilize electric prices.

SRP's RSF is funded at the discretion of its Board of Directors (Board). SRP does not have a separate charge/fee in its electric price plans to fund the RSF. The first funding was in April 2005 for an amount of \$55 million that has already been used to off-set fuel expenses through the summer of 2006. The second funding of \$80 million was authorized in July 2006 for potential mitigation of fuel expense through the end of April 31, 2008.

The funds that have been dedicated to the RSF generally have resulted from better than anticipated financial performance in wholesale sales, and below budget reductions in operating expenses of any and all types. Either of these occurrences source cash which can be dedicated to the RSF. Conversely, if financial and operational performance is poorer than expected, then there is no commitment to fund the RSF.

In a broader context, the RSF is supportive of the Board's Pricing Philosophy, in particular the tenet of gradualism. Embedded in the principles are efforts to proactively manage against price volatility, and the RSF is a program that supports those principles.

## II. Survey of Rate Stabilization Funds in the Utility Industry

Rate Stabilization Funds are used by a variety of utilities as a means to smooth price trends for customers. Below are brief descriptions of public power utilities that have employed such a mechanism. This list is not a comprehensive review of all utilities.

### **Austin Energy (AE)**

AE has a fund called the Competitive Strategy fund. This fund is used for emergencies and to improve competitive position. Acceptable uses include: funding capital needs in lieu of new debt, reduction of outstanding debt, improving the debt to capital ratio, rate reductions, and new technology. The current reserves in the fund exceed \$170 million.

According to their Finance and Corporate Services group, this is now called the "Strategic Reserves Fund" and has four uses –

- 1) Emergency – Use only as a last resort to provide funding in the event of an unanticipated or unforeseen extraordinary need of an emergency nature – up to 60 days of operating cash set aside
- 2) Contingency – Use for unanticipated or unforeseen events that reduce revenues or increase obligations – up to 60 days of operating cash set aside
- 3) Competitive – Funding capital needs in lieu of debt issuance, reduction of outstanding debt, rate reductions, acquisitions of new products and services, new technologies – up to 120 days of operating cash set aside
- 4) Repair Replacement Fund

Rate Stabilization may be addressed under the Competitive use.

Source: [www.austinenergy.com](http://www.austinenergy.com) About Us > Company Profile > Budget > Austin Energy Budget

### **Sacramento Municipal Utility District (SMUD)**

SMUD had a rate stabilization fund from 2001 until May 2004. It was funded through a \$0.0025/kWh surcharge. The Board decided to allow the charge to expire due to concerns about low income customers and comments from business customers that were counting on the charge to expire as promised. It was intended to maintain a \$70 million fund.

Source: [www.smud.com](http://www.smud.com), News Release dated February 6, 2004 "SMUD drops surcharge keeping promise to customers"

### **Municipal Electric Authority of Georgia (MEAG Power)**

MEAG established the Municipal Competitive Trust (MCT) in 1999. The fund level is \$650 million as of 12/31/05 and is funded by 49 municipal Participants located throughout Georgia. The funds are held by an external trustee and can only be used to keep rates competitive in the event of retail competition. This is funded with rate stabilization, debt service reserve, and Participants' discretionary funds.

*Source: [www.megapower.org](http://www.megapower.org), 2005 Annual Statement or the Years Ended December 31, 2005 and 2004, pg. 34, Notes to Financial Statements "The Municipal Competitive Trust"*

### **City of Tallahassee, Electric**

City of Tallahassee has a Long Term Rate Stabilization Reserve. The balance of this fund was roughly \$49 million in 9/05. The fund is used to offset rate increases or for rate stabilization and appears to have been created in 1995.

All electric fund surpluses (defined as operating fund balances in excess of the targeted transfer less bond reserve requirements) shall be used to fully fund the long term rate stabilization reserve, with any differential surplus being retained in the fund and made available for any lawful capital project within that fund after meeting identified reserve requirement.

*Source: [www.talgov.com](http://www.talgov.com), Government > City Commission > Policies, City Commission Policy 224 – Financing the Government, 224.05 II. Surpluses C. Electric Fund*

### **Modesto Irrigation District (MID)**

The MID fund is called a Rate Stabilization Fund. The stated goal is to protect customers from extreme rate increases that would otherwise be necessitated by dramatic short-term changes in purchased power or other operating costs. The Board determines the annual transfers into/out of the fund, which may utilize these unrestricted funds for any lawful purpose. Funds are unrestricted and are part of the General Fund. The balance at the end of 2005 was \$53.75 million.

*Source: [www.mid.org](http://www.mid.org), 2005 Annual Report, Notes to Consolidated Financial Statements, Years ended December 31, 2005 and 2004, pg. 29.*

### **Wisconsin Public Power (WPP)**

WPP established a Rate Stabilization Fund in 1992. Currently, any earnings in excess of 110% of debt coverage may be added to the fund or used for other purposes at the Board's discretion. The fund level is currently \$35.8 million.

*Source: [www.wppisys.org](http://www.wppisys.org), 2005 Annual Report, Financial Statements, Management's Discussion and Analysis, pages 3 & 16.*

**Metropolitan Water District of Southern California (MWD)**

MWD established the Water Rate Stabilization Fund (Fund No. 5501) in 1987. This fund is for the principal purpose of reducing water revenue requirements in order to smooth water rate adjustments over time. Current policy provides that financial operations be managed to produce a minimum unrestricted reserve balance – the Water Revenue Remainder Fund. Any funds in excess of the Water Revenue Remainder Fund on June 30 of each year are transferred to the Water Rate Stabilization Fund. Notwithstanding the principal purpose of this fund, amounts assigned may be used by the Board for any lawful purpose.

Source: [www.mwdh2o.com](http://www.mwdh2o.com), Revenue Bond Official Statement Series 2006 Bonds, pages A38-39.

**Northwest Territories Power Corp. (NWTP)**

NWTP has a Rate Stabilization Fund held as a regulatory asset. The Fund helps mitigate the impact on utility rates of changes in diesel and natural gas fuel prices as well as fluctuations in hydro generation caused by changing water levels. The impact of any increases or decreases in fuel prices or hydro generation over the Board approved amounts is deferred. The deferred amounts are accumulated until specified limits are reached (\$2MM), at which time rate-riders are applied, with Board approval, to recover or refund the amounts necessary to bring the funds back to the approved limits.

Source: <http://www.ntpc.com/newsbar/faq/fuelstandardfund.pdf>

**Seattle City (Water)**

Ordinance 114276, approved by a vote of 8 to 0, establishes a rate stabilization fund to strengthen the finances of Seattle Public Utilities, the city department that provides drinking water to 1.3 million residents in Seattle and throughout King County.

There is a minimum balance required for the sub-fund. This minimum balance must be maintained except when withdrawals below this level are needed to offset shortfalls in metered water sales revenues, or to meet financial policy requirements. Withdrawals of funds in excess of the minimum balance will be used to meet operating expenses, to pay Capital Improvement Program expenditures, or to meet financial policy requirements. Should the balance in sub-fund fall below the target balance, within one year Seattle Public Utility shall submit a water rate proposal that rebuilds the balance in the sub-fund. Withdrawals from the sub-fund must be authorized by ordinance.

All customers contribute to the funds through their rates. The amount each class of customers pay is in the rate. It is not highlighted on the bill. When Seattle implements a rate proposal, the amount for each class depends on how much they have to collect to keep the minimum balance in the account. The City

Council will determine how much time they will have to get the account back to the minimum balance.

Source: [http://www.seattle.gov/mayor/issues/water\\_rates.htm](http://www.seattle.gov/mayor/issues/water_rates.htm), Finance Planning Unit, Seattle City Light.

### **III. Application of RSF in SRP's price plans and support of our Pricing Philosophy**

Earlier in the decade, SRP undertook a plan to improve its operating efficiency and financing flexibility so that it is better positioned to remain competitive and to respond to future changes. The Recapitalization plan resulted in a series of debt issuances in order to refund certain outstanding Revenue Bonds.

The goals of the Recapitalization Plan were: (1) to accelerate debt retirement by the District of its Revenue Bonds; (2) to provide the District with increased financing and operating flexibility in the future; (3) to issue new Revenue Bonds for distribution expenses; (4) to adopt a modern and more flexible bond resolution; and (5) to recognize debt service savings.

As part of the goal to adopt a modern and more flexible bond resolution, SRP's Board authorized through resolution dated September 10, 2001 an Amended and Restated Resolution Concerning Revenue Bonds. That Resolution included a provision to establish a rate stabilization fund. The specific reference from that resolution is provided below:

**“Rate Stabilization Fund.** 1. There may be deposited in the Rate Stabilization Fund any amounts deemed necessary by the District to be used for any lawful purpose of the District, including but not limited to making any deposits required by the Resolution to any Fund, as determined by the District; provided, however, that no such deposit to any such Fund shall be required; provided further, however, that if at any time the amounts in the Operating Fund or Debt Service Fund shall be less than the current requirements thereof, the District shall withdraw from the Rate Stabilization Fund and deposit in such other Funds the amount necessary (or all the moneys in the Rate Stabilization Fund, if less than the amounts necessary, applying available amounts in the order of priority and otherwise as specified in Section 5.06) to make up such deficiency. Amounts on deposit in the Rate Stabilization Fund may be invested by the District to the fullest extent practicable in Investment Securities. The District may sell any such Investment Securities at any time, and the proceeds of such sale, and of all payments at maturity and upon redemption of such investments, shall be held in the Rate Stabilization Fund. Interest received on moneys or securities in the Rate Stabilization Fund shall be deposited in the Rate Stabilization Fund. Amounts in the Rate Stabilization Fund which the District may determine to be in excess of the amount required to be

maintained therein shall be transferred to the Revenue Fund. Amounts on deposit in the Rate Stabilization Fund are not subject to the lien or pledge created by the Resolution.”

In 2000, SRP formally adopted has a Pricing Philosophy to reaffirm SRP’s responsibility as a publicly-owned electric utility, whose operations are shaped by the public interest, to provide affordable and reliable electricity to its customers. Embedded in the principles embedded are SRP’s long-standing policy and practices to proactively manage against price volatility. Other critical success factors for SRP to adhere to the Pricing Philosophy include the timely addition of resource assets, effective utilization and availability of internal generation, and prudent legislative and regulatory guidelines.

SRP’s Board approved and adopted the Pricing Philosophy as a part of SRP’s Terms and Conditions and directed management to continue to use these principles in pricing electric service to SRP’s customers. The basic principles for pricing electric service are as follows:

*Gradualism* – to enhance sound economic decision-making by customers of all types by stabilizing price levels and smoothing the impacts of cost movements that may be caused by temporary factors

*Cost Relation* – to establish prices in relation to costs and SRP’s stewardship to its water constituents, and thus not to pursue the maximization of “profit”

*Choice* – to constantly improve customer satisfaction through the creative design of pricing structures that reflect customers’ different desires and abilities to act

*Equity* – to treat customers of all types in an economically fair manner

*Sufficiency* – to recover the cost of, and invest and reinvest in, a system of assets necessary to meet the demands of SRP’s customers; to perform valid policy obligations; to maintain SRP’s financial well being and to practice the foregoing principles

The establishment and use of a RSF to assist in the stabilization of prices is in keeping with the principles above, notably gradualism. SRP’s Board has twice authorized the funding of the Rate Stabilization Fund to be used in concert with SRP’s Fuel and Purchased Power Adjustment Mechanism in order to assist in the stabilization of electric prices related to fuel.

The mechanisms for funding a Rate Stabilization Funds (RSF) can vary by utility. Some methods are formula driven while others are funded through discretionary actions of their Board or regulatory authority. For investor-owned utilities, this

usually relates to earnings above an established return on equity threshold. Other formula based approaches may use a per kWh surcharge as a funding source.

In practice, SRP's RSF has been funded at the discretion of the SRP's Board of Directors, not a prior approved formula. The amounts funded generally have been related operational savings or wholesale revenues that have exceed planned levels.

In April 2005, SRP's Board authorized the deposit of \$55 million into the RSF to be used to cover fuel related expenses and/or to stabilize future prices related to fuel during fiscal years 2006 and 2007. The \$55 million was applied to the fuel and purchased power balance on May 1, 2006 to address a portion of fuel and purchased power costs during the 2006 summer season. It has been spent.

In July 2006, SRP's Board authorized the deposit of and additional \$80 million into the RSF to be used to cover fuel related expenses and/or to stabilize future prices related to fuel through the end of fiscal year 2008.