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AZ CORP COMMISSION
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August 29, 2008

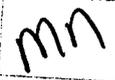
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Docket Control
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Arizona Corporation Commission
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AUG 29 2008

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Re: *Arizona Investment Council Responses in the Commission's Investigation of Regulatory and Rate Incentives; Docket Nos. E-00000J-08-0314 and G-00000C-08-0314*

Dear Sir or Madam:

Enclosed are the original and 13 copies of the Comments of the Arizona Investment Council in response to the Commission's investigation of regulatory and rate incentives for gas and electric utilities.

Very truly yours,

GALLAGHER & KENNEDY, P.A.



By:

Michael M. Grant

MMG/plp
18762-1/1895059

cc (w/enclosure) (delivered): Commissioner Mike Gleason, Chairman
Commissioner William A. Mundell
Commissioner Jeff Hatch-Miller
Commissioner Kristin K. Mayes
Commissioner Gary Pierce
Barbara Keene, Utilities Division

Original and 13 copies filed with Docket Control this 29th day of August, 2008.

Investigation of Regulatory and Rate Incentives for Gas and Electric Utilities

Docket Nos. E-00000J-08-0314 and G-00000C-08-0314

Comments of Arizona Investment Council

August 29, 2008

The Arizona Investment Council ("AIC") is pleased to submit its comments in response to the Arizona Corporation Commission's ("ACC" or "Commission") investigation of regulatory and rate incentives for gas and electric utilities. Our response provides AIC's general comments followed by answers to the specific questions posed by Staff.

General Comments

As the ACC is well aware, numerous utility regulatory commissions at both the federal and state levels (including Arizona in the past) have adopted ratemaking policies, procedures and practices which have led to more efficient regulatory oversight of utility companies, while simultaneously encouraging the companies to lower costs and improve service to customers. The implementation of such incentive ratemaking mechanisms has (1) led to better utilization of societal resources, (2) established regulatory environments that encourage necessary and prudent capital investment at the lowest possible costs and (3) preserved the integrity of regulatory decisions over pricing and service quality.

For example, revenue decoupling, an innovative ratemaking mechanism presently used in several jurisdictions (and under consideration here in the Southwest Gas rate case), removes the built-in disincentive for gas and electric utilities to fund and promote conservation programs for their customers. For companies facing declining per-customer

revenue due to conservation, revenue decoupling severs the link between volumetric sales and earnings, thus making the utility companies indifferent to selling more volume. Thus, more efficient use of scarce resources is promoted.

AIC also believes the Commission could implement ratemaking policies that encourage investment in infrastructure and the attraction of capital at reasonable costs. Absent a fresh look at alternative ratemaking mechanisms—in today’s era of rising costs for fuel and construction materials—Arizona gas and electric utilities will remain at a significant disadvantage as they compete for capital in meeting future infrastructure requirements. The current, backward-looking Arizona rate regulatory system, coupled with today’s volatility and inflationary pressures, results in significant earnings attrition, which imperils the utility companies’ financial health. The regulatory lag in the current system inhibits synchronization of costs with prices for utility services, leading to higher costs of capital and ultimately higher price increases for customers. AIC encourages the Commission to look at innovative ratemaking mechanisms that are forward-looking, including but not limited to, utilization of future test years, revenue decoupling, rate base treatment of construction-work-in-progress (“CWIP”), price caps, rate indexing and inflation adjustments, attrition adjustments, earnings inducements for investment in alternative or renewable energy facilities and more timely base rate adjustments. In short, all alternatives should be put on the table for consideration.

As Arizona nears and exceeds the capacity of its native generation resources energy, companies must build or acquire new generation and transmission resources in the near future. For example, a recent study by AIC indicates that an additional \$65 billion to \$77 billion in electric generation, transmission and distribution investments will be

required over the next 25 years. Arizona utilities are competing constantly with other utility companies and businesses for equity and debt capital to meet huge investment requirements. Investors look most favorably at those areas where utility companies have the best opportunity to provide adequate returns, given the level of risk.

AIC urges the Commission to reform the Arizona ratemaking scheme in a way that eliminates the obstacles to investment that currently exist and replace it with processes, mechanisms and incentives that encourage investment and provide customers and the citizens of Arizona with the benefits of safe and reliable service at reasonable rates.

AIC also urges the Commission to look at policy and regulatory process so as to streamline regulation. In its answer to question #13, AIC lists several other broad areas in which the Commission can improve processing efficiency.

Responses to Specific Questions

Q1: What basic incentives and disincentives does today's regulatory structure (e.g., rate-of-return regulatory structure, adjustment clauses, test year determination, depreciation policies) provide to Arizona electric and gas utilities?

Answer: In today's economic environment of escalating fuel costs, rapidly rising construction costs, continued population/customer growth and the deteriorating financial health of many Arizona utility companies, gas and electric companies are left with little incentive under the current ratemaking approach but to file repeated requests with the ACC to adjust rates. While traditional historical test year rate-of-return regulation can work reasonably well in an era of adequate capacity, stable fuel prices and low inflation, its limitations are all too obvious today. Today's circumstances are quite similar to those

of the 1970s and 1980s as Arizona's utilities built necessary plant—which has served the State well—in very volatile capital, inflationary and fuel markets. Coupled with the fiscal drag occasioned by the typical 13- to 18-month (or longer) time frame to complete a rate case, Arizona's backward-looking ratemaking process provides little comfort to investors asked to place capital at risk with Arizona utility companies. As a result, the credit ratings of Arizona's largest investor-owned electric and gas companies are pushing junk bond status due in large measure to Arizona's regulatory paradigm.

While the delays inherent in Arizona's ratemaking system for granting rate increases may seem, at first blush, a good thing for customers, they only lead to more risk, higher long-term costs/prices for customers and a temporal mismatch of energy use and costs. A good ratemaking system should be sufficiently timely and flexible to provide investors adequate confidence that companies will have the opportunity to recover prudently-incurred costs plus a reasonable return and provide customers with proper price signals as they consume scarce energy resources.

AIC is pleased that the Commission has implemented purchased power and fuel adjustor and gas recovery clauses for several gas and electric companies to enable recovery of prudently-incurred fuel costs. However, AIC would note that the mechanism currently in place for Arizona Public Service Company only allows the company to recover 90 percent of its rising fuel costs. That treatment does not, as intended, act as an "incentive" for the company to lower its fuel costs. In this rising cost environment, the 90/10 "sharing" is simply a 10 percent disallowance of prudently-incurred costs.

Gas and electric companies should be afforded the opportunity, through adjustor clauses, to recover all, or 100 percent, of their prudently-incurred energy costs. If the Commission wishes to consider adding incentives to clauses, they should recognize that a properly constructed incentive provides equal opportunity for the company to earn both performance rewards and penalties.

Q2: What are the alternatives to the Rate Base-Rate of Return model?

Answer: There are numerous alternatives to the Rate Base-Rate of Return model that provide incentives for electric and natural gas utilities to deliver superior customer service while maintaining returns sufficient to attract investors. These mechanisms have been implemented in jurisdictions throughout the United States as well as internationally. These are not new concepts. Many have been in place in various jurisdictions for decades. Indeed, the Commission itself has implemented versions of incentive ratemaking in the past. Additionally, the literature is rich with information about these mechanisms—how they work, as well as comparative advantages and disadvantages. Most of these fall under the generic heading of Performance or Incentive-Based regulation.

Specific examples of this type of regulation include:

- Price cap – where a company's prices and not its profits are regulated in a manner such that customers see price changes that are indexed to a range of inflation while the company has the opportunity for additional earnings by being more productive;

- Revenue cap – where a regulated utility is able to set its own prices so long as it does not increase its revenue per customer by a set amount, thereby enhancing conservation by reducing the incentive for a company to maximize commodity sales;
- Earnings sharing – where either reductions in production costs from a set level and/or increases in a firm’s Return on Equity (“ROE”) from the Commission’s authorized amount would be shared between the company and its customers; and
- Combinations of these have been used by the ACC in the past (*see, for example, the incentive/sharing mechanism implemented for Arizona Public Service Company, May 1994*).

Some incentives can be added to the Rate Base–Rate of Return model itself. Examples include:

- Rate indexing – where, for example, a company’s base rates could be adjusted on a set schedule based upon the price of fuel or changes in power supply costs; and
- The earnings sharing mechanism stated above.

The Commission might also consider an approach to ratemaking currently in practice in California. The California model provides for mandatory periodic review of rates in a full rate case, with various adjustment mechanisms for the interim periods between rate cases. This system is easy to implement and works well for both companies and customers.

Q3: How do adjustment clauses affect utility incentives?

Answer: The extent and manner in which adjustment clauses affect utility incentives depends on the provisions of the adjustment clause.

For example, a well-constructed cost adjustment clause could provide a reward for management performance that achieves or exceeds a certain level. Let's say a company is able to "beat" an established index of purchased power and fuel costs. The company could be rewarded by being allowed to keep a portion of its cost savings. If, on the other hand, management performance was below an established index or level, the company would be penalized and not allowed to recover all its costs. Such an adjustor would provide an equal opportunity for the company to be rewarded or penalized. The result is that management has an incentive to do well and to avoid poor performance.

An adjustor that simply penalizes the company under the guise of a "sharing mechanism" is not an incentive mechanism at all. It is simply a penalty. It provides no additional incentive for the company to perform at an exceptional level.

Q4: What are possible alternatives to adjustment clauses?

Answer: Rate indexing or other alternative forms of regulation such as price caps would be forms of alternatives to adjustment clauses.

Q5: Are incentives an appropriate tool to use in the context of fuel/gas procurement activities?

Answer: If properly structured to provide a reasonable opportunity for reward, incentives could lower costs below what might otherwise be achieved.

Q6: Can the regulatory incentive structure be changed to align a utility's financial incentives with energy efficiency investment?

Answer: Yes. As one example, *see* Dr. Daniel Hansen's testimony in the Southwest Gas Corporation rate case on behalf of the Arizona Investment Council in Docket No. G-01551A-07-0504.

Additionally, the Commission could consider providing gas and electric companies an extra incentive for "green" investments by allowing a return or bonus to be earned on energy efficiency investments. The Commission would need carefully to consider how such a mechanism would be structured to ensure that its energy efficiency goals were properly met.

Q7: Can the regulatory incentive structure be modified to heighten the utility's incentives for management efficiency?

Answer: Large corporations like Arizona's large gas and electric utility companies have internal incentive programs that guide management's efforts to maximize shareholder value by managing costs and achieving efficiencies while keeping customers satisfied and rates as low as possible.

Any Commission incentives should carefully consider these programs and objectives, including the alignment of management incentives with customer incentives to ensure delivery of safe and reliable service at reasonable prices.

Q8: Can incentives play a role in Arizona efficiently meeting its future utility infrastructure needs?

Answer: Yes. There are multiple ways in which incentives can play a role in meeting future utility infrastructure needs.

As one example, utility companies could be provided an opportunity to earn a bonus if they build renewable energy infrastructure under conditions established by the Commission.

There are many other incentives that could be structured to improve the companies' ability to acquire capital at the lowest possible costs and assist in achieving various infrastructure scenarios. For example, allowing construction-work-in-progress in rate base would lower long-term financing costs for large infrastructure projects. This would also benefit customers by lowering rates over the long-term. Allowing a post-test-year adjustment to recognize plant added and used and useful by the time of the inquiry would be beneficial. Utilization of future test years in rate cases would provide similar benefits.

Other examples include pre-approval of infrastructure projects and ROE adders for particular infrastructure projects, as well as other adjustors to facilitate recovery of capital expenses.

Q9: Should the Commission consider "decoupling" mechanisms for electric and gas companies? If so, what types?

Answer: Yes. Many forms of decoupling have been adopted in various jurisdictions. AIC supports full revenue decoupling as set forth in Dr. Hansen's

testimony in the Southwest Gas Corporation rate case on behalf of the Arizona Investment Council, Docket No. G-01551A-07-0504. AIC believes the Commission should examine the practicality of extending the concept of decoupling to other utility companies where it makes sense and facilitates full recovery of prudent infrastructure costs.

Q10: Can the regulatory incentive structure be altered to change the stakes for a utility making a build-or-buy decision or other infrastructure decisions?

Answer: Yes. However, such incentive structures must be carefully constructed so as not to result in unnecessary costs or impaired long-term reliability and safety.

Whatever approach is taken, companies must be able to manage their resource additions to ensure safe and reliable service and with sufficient flexibility to manage costs as well.

Q11: What impact does the current regulatory structure regarding the buy-or-build scenario have on competitive bidding as a tool in resource selection?

Answer: The present system, absent CWIP or other allowances, precludes companies from earning a return on infrastructure until it is deemed “used and useful” in a future rate case and thus impacts the “build decision.”

Various uncertainties in the current regulatory structure may also impact the “buy” decision.

Q12: What are the best practices across the nation regarding regulatory incentives?

Answer: AIC has not performed a review and analysis of all regulatory incentives in practice in other jurisdictions to determine specific best practices. However, in 1993, the National Regulatory Research Institute published a paper entitled "The Effects of Fuel-Related Incentives on the Costs of Electric Utilities" in which the authors identified five tasks that regulators must perform in establishing incentives. They are:

1. Ascertain standards for utility performance (with input from utility companies);
2. Identify linkages between performance standards, rewards and penalties;
3. Identify the markets affected by fuel-related incentives;
4. Estimate the expected reductions in costs; and
5. Arrange rewards and penalties in a manner consistent with expected cost reductions.

It would seem any incentive structure that the ACC considers should incorporate these important tasks.

Q13: Are there any other specific topics that should be covered in the inquiry?

Answer: Yes. The Arizona Investment Council has given considerable thought to what types of incentives can be used to help the Commission reach its goals.

We believe that instituting certain administrative reforms as well as policy changes will provide regulated utilities with opportunities and incentives to:

- Focus on their core businesses;
- Provide superior service; and

- Introduce new and innovative services and service delivery methods.

AIC believes such comprehensive regulatory reform would also allow the Commission to achieve its goal of protecting the public interest in the most efficient and effective way possible, given the resource constraints of time and funds.

Specifically, AIC recommends this investigation also consider:

13.1 Methods to expedite decision making on tariff matters. This could include consideration of:

- Methods to allow more tariffs to take effect by operation of law;
- Expanded use of the Consent Agenda; and
- Dedicating specific staff to tariff filings.

13.2 Methods to reduce the frequency and expense of processing general rate cases, such as:

- Encouraging settlements where appropriate;
- Allowing the use of a future test year and other, different rate case approaches; and
- Revisiting the time clock rules used by the Commission in processing rate cases. These rules were implemented over 15 years ago and have not been updated for changes in revenue ceilings used in classifying processing time frames or for changing market structures. The Commission may also want to consider expanding the time clock rules to other matters, including processing of Certificates of Convenience and Necessity (“CC&N”).

- 13.3 Changing its regulatory treatment of electric cooperatives to reflect the special member/owner relationship of cooperative customers to achieve a more efficient and light-handed regulatory approach.
- 13.4 Further streamlining certain telecommunications processes, such as:
- Eliminating certain filings in favor of web postings; and
 - Significantly streamlining the CC&N process for competitive local exchange carriers similar to other states' mechanisms.
- 13.5 Methods to reduce the amount of staff time spent on regulating small water companies and encouraging small water company consolidation. (Many such recommendations were made by the ACC Water Task Force and are still valid and should be implemented by the Commission.)
- 13.6 Taking advantage of technological improvements to allow electronic filings of some documents.

AIC believes that consideration of these issues should also be a part of the investigation and will provide incentives to utilities to provide superior service, be consistent with Commission goals and protect the interests of the public and regulated utilities alike.

Q14: Are there any legal impediments?

Answer: If carefully constructed, AIC believes the Commission can achieve substantial reform of its regulatory process to implement appropriate ratemaking incentives while explicitly meeting the constitutional requirement that the Commission determine "fair value." AIC believes such reforms can be implemented without violating any constitutional or statutory standards and would work to benefit customers and shareholders alike and reduce the costs of regulation for companies and the Commission.