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2008 AUG 29 P 4: 41
AZ CORP COMMISSION
DOCKET CONTROL

August 29, 2008

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

RE: INVESTIGATION OF REGULATORY AND RATE INCENTIVES FOR GAS AND ELECTRIC UTILITIES – DOCKET NOS. E-00000J-08-0314 AND G-00000C-08-0314

Dear Sir or Madame:

Enclosed are Arizona Public Service Company's ("APS") comments on the list of questions assembled by Commission Staff as defining the scope of the investigation in the above-captioned matter, which were attached to a letter from Mr. Ernest Johnson filed in this docket on August 1, 2008. Pursuant to Mr. Johnson's request in that letter, APS is filing the original and 13 copies of these comments with Docket Control.

If you have any questions or concerns please let me know.

Sincerely,

Barbara Klemstine

Arizona Corporation Commission
DOCKETED
AUG 29 2008
DOCKETED BY

BK/dst

Attachments

CC: Ernest Johnson
Barbara Keene
Janice Alward
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Parties of Record

COPY of the foregoing was mailed or emailed this 29th day of August, 2008, to:

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Comments of Arizona Public Service Company ("APS" or "Company") as to the Scope of the Proceeding

In a letter dated August 1, 2008, Arizona Corporation Commission ("Commission") Utilities Director, Mr. Ernest Johnson, informed potential parties that the Commission had opened a docket for the Investigation of Regulatory and Rate Incentives for Gas and Electric Utilities, Docket Nos. E-00000J-08-0314 and G-00000C-08-0314. In that letter, Mr. Johnson requested two things: (1) that all parties desiring inclusion in such docket send notice to the Commission of their interest[1]; and (2) that interested parties comment on a list of questions provided by Staff that were intended to define the scope of the inquiry and to identify any additional issues and/or questions that might be addressed during the course of the investigation.

The Company's comments on the appropriate scope and methods of inquiry in this investigatory docket are provided below. APS looks forward to discussing the substance of these inquiries as the proceedings in this docket progress.

Overview

APS appreciates the opening of this investigatory docket and looks forward to actively participating in the discussion of these important issues. As the Commission is aware, the world's energy landscape has changed dramatically over the past decade: energy system needs and costs are rising simultaneously, increasing utilities' capital investment; customer growth continues, exacerbating that cost-pressure; new customer-beneficial technologies are emerging, which require substantial funding but are important to implement; and concerns regarding sustainable and diverse energy resources have resulted in policies that require increased investment in renewable energy, energy efficiency, more sophisticated pricing, and better protection of low income customers – all worthy but sometimes costly goals, which further increase utility costs. Given this changing landscape and the recent shift in both state and national energy policy, the traditional regulatory structure in which Arizona utilities now operate (particularly, the use of a historical test year that results in long lags between financial decisions and cost incurrence by the utility and prudence determinations and the recovery of those costs through rates) is no longer appropriate without significant change. The issues identified and the questions posed for consideration in this docket, among others, are thus critical and timely to determine whether Arizona's regulatory structure creates unintended encumbrances or disincentives for regulated utilities and whether fresh approaches are warranted.

APS believes that several overarching issues should be considered when conducting this investigation. First, although growth has slowed to more modest levels in Arizona for the short term, significant new capital investment from Arizona utilities is still required and growth will again return to levels that exceed virtually all other areas of the country. Coupled with inflationary pressures on core commodities needed to provide utility service in addition to high foreign exchange rates and overseas demand for

[1] APS previously provided the requisite notice on August 11, 2008.

equipment, growth and system maintenance needs require Arizona utilities to continue to make significant capital investments in basic electric system infrastructure.

In addition, resource planning for Arizona utilities is undergoing a dramatic transformation as utilities rely more on renewable and distributed generation resources, address the challenges of carbon risk in making resource decisions, deal with the need to plan for new base load resources that demand lengthy lead times, implement new and more flexible rate options for customers, and increase the implementation of energy efficiency. The new resource planning paradigm has shifted from the traditional "least cost" planning of the 1970s and 1980s, and requires utilities to make additional – and significant – capital investments that may cause short term rate increases, but that will ultimately lower the environmental impacts of providing energy service, reduce long term fuel risk, provide enhanced customer choice, and encourage energy efficiency. While the resource decisions arising from these factors will require significant utility investment and increase utility expenses, they will also achieve important policy goals set by the Commission and other policy-makers.

The current energy landscape thus poses substantial risk and financial challenges to utilities. Compounding this challenge is Arizona's traditional practice of using a historical test year. The use of historical test years without adjustments or other mechanisms requires the utility to make all of its decisions and commitments without certainty of cost recovery, and imposes long delays between when a cost is incurred and when that cost is recovered through rates. This period of lag not only postpones the recovery of some costs, it also renders utilities unable to ever recover significant costs that are prudently incurred in providing utility service, because depreciation expense and capital carrying costs begin for new investments when they are placed in service, generally many months prior to when new investments are recognized in rates. As a result, the regulatory lag resulting from Arizona's traditional regulatory structure has a profound impact on a utility's financial condition and provides utilities with a *disincentive* to make investments in needed infrastructure, innovative technologies, and sustainable energy resources, among other things.

In such a challenging cost-environment, it is critical that the Commission explore flexible mechanisms that provide for timely and more certain cost recovery and that facilitate needed capital investment. APS believes that, in the context of today's financial and operational environment, it is vitally important for the Commission to examine not only the incentives that might be implemented but the disincentives that exist under Arizona's current regulatory structure, and to consider alternative rate and regulatory mechanisms that would better encourage utilities to continue making investments in the resources and programs that benefit both customers and the Company alike. In addition, the Company believes that this docket provides an excellent opportunity to evaluate the Commission's policies and procedures from a more global perspective in order to identify and adapt any currently existing processes that now pose a barrier to parties and the Commission from implementing important policy goals.

Comments on the Scope of Proceeding

APS believes that the issues identified in Staff's "Questions to Assist in Defining the Scope of the Inquiry" generally capture the key issues for consideration in this docket. To facilitate discussion on those issues, APS believes that it would be beneficial to identify at the outset the various interests that will be impacted by the investigation, including a thorough evaluation of the nature of the utility interests, customer interests, and public policy goals sought to be aligned in any alternative regulatory structure. In addition, the Company suggests that the scope be broadened from consideration of only incentives to include the avoidance of potential *disincentives,* as well as the modification of existing policies and procedurals that currently provide a barrier to the effective achievement of important policy goals. Doing so would broaden the scope of the discussion beyond typical single-issue financial "incentive mechanisms" and include a discussion about how the broader regulatory framework might be adjusted in order to properly balance the interests of all stakeholders.

Finally, as the following comments indicate, the Company believes that some of the questions should be clarified or expanded upon so as to elicit information and discussion on the issues without suggesting a specific conclusion before the information is obtained. APS will comment on each question in turn, in the order in which it was presented.

Question 1: 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?

This question identifies the fundamental issue raised by the Commission's inquiry. A key opportunity that this docket provides is to allow interested parties and the Commission a forum in which to globally analyze and evaluate Arizona's current regulatory structure and to identify how today's policies and procedures might be adapted to better enable parties and the Commission to work together to implement important public policy goals. As this question suggests, the discussion should transcend the discrete examination of a few single-issue financial incentive mechanisms (though a discussion of such mechanisms is important and should be included as part of the global discussion), and should instead examine the current regulatory model as a whole to determine where it provides opportunities to achieve these goals and where it provides obstacles to their achievement. A discussion of this overarching issue should also elicit substantive responses that will help mold specific additional inquiries to examine as the discussions in this matter progress. APS therefore suggests that interested parties and Staff devote substantial attention and resources to consideration of this issue.

Question 2: What are the alternatives to the Rate Base – Rate of Return model?

While APS agrees that this concept is important to consider, the Company also suggests that it be broadened to consider all aspects of the current rate making model. The allowance of a reasonable rate of return is only one factor in determining utility

earnings, and a focus on that factor alone will be inadequate to identify the incentives and disincentives contained in the regulatory structure as a whole. The broader question, which captures all relevant factors, is whether Arizona's current approach to basing rates on historic test-year revenue requirements, coupled with regulatory lag, is optimal, or whether an alternative framework might better align utility and customer interests. To sufficiently capture this breadth, and allow for exploration of many variations of today's regulatory model, the Company suggests that the Commission include in the scope of this question a consideration of (1) the alternatives to setting rates based on a determination of historical test year revenue requirements and billing determinants; (2) the alternative approaches to implementing the traditional test-year approach to ratemaking; and (3) the incentives and/or disincentives that each of these alternatives may provide.

Question 3: How do adjustment clauses affect utility incentives?

The Company agrees that this, too, is an important inquiry. APS suggests that, like the previous question, this question should also be broadened so as to expand the focus beyond utility incentives and include an evaluation of the customer and public-policy interests involved in the use of adjustment mechanisms. In this regard, Staff should consider including as part of the scope of this discussion an examination of whether adjustment clauses affect utility incentives and/or disincentives, and what types of adjustment clauses may either reduce overall customer costs or better serve state public-policy objectives.

Question 4: What are possible alternatives to adjustment clauses?

APS agrees that this is an important question (and one that might naturally be resolved in the discussion of questions one through three). Nevertheless, because the Company believes it is important that any possible alternatives be weighed against adjustment clauses, the Company proposes that this question also include a consideration of the relative advantages and/or disadvantages of the alternatives identified.

Question 5: Are incentives an appropriate tool to use in the context of fuel/gas procurement activities?

While the Company agrees that this is an important issue to consider, the question as asked limits the discussion to an examination of "incentive" mechanisms rather than examining how procurement activities could be benefited by an evaluation of the current regulatory structure as a whole. For that reason, the Company believes that it would be enlightening to broaden the inquiry to include not only "incentive" mechanisms per se, but other regulatory policies or processes that might be appropriate in order to remove any financial disincentives or procedural hurdles now in place under the current regulatory structure for fuel/gas procurement activities. The Company therefore proposes that the question include consideration of incentives and/or disincentives that exist under the current regulatory framework that impact fuel/gas procurement activities, whether modifying that framework would be appropriate in light of those incentives/disincentives, and, if so, how could/should that framework be modified.

Question 6: Can the regulatory incentive structure be changed to align a utility's financial incentives with energy efficiency investment?

APS agrees that this is an extremely important issue to evaluate, given the increasing importance of energy efficiency. The Company suggests that this question be broadened to avoid limiting the discussion to a discrete consideration of blunt energy-efficiency financial incentive mechanisms, rather than a broader inquiry into how the current regulatory structure and regulatory policies impact investment in energy-efficiency measures, and how those policies might be changed in order to better align customer and utility interests and meet other public policy goals. In addition, to broaden the inquiry beyond "energy efficiency" (*i.e.,* demand-side management) measures, the question could be expanded to include additional public programs or initiatives also geared to promote energy efficiency. The Company therefore suggests that the inquiry be expanded to evaluate (1) what incentives/disincentives exist under the current regulatory framework that impact a utility's investment in energy-efficiency programs, load-management programs, dynamic pricing initiatives, and initiatives to encourage distributed generation; (2) whether modifying that framework would be appropriate in light of those incentives/disincentives; and (3) if so, how could/should that framework be modified.

Question 7: Can the incentive structure be modified to heighten the utility's incentives for management efficiency?

To address this issue, it is important to discuss what is meant by "management efficiency" or place it in the appropriate context. Reducing total costs of service is an important goal, but not likely the only goal sought to be achieved through cost-of-service regulation. The goal of reducing costs must be balanced against other policy goals, including an interest in maintaining reliable and affordable electric service, providing exceptional customer service, protecting the environment, and providing the utility the financial ability to make investments that will provide long term benefits to its customers and the state's economy. In today's environment of increasing costs, it is dubious that any such cost reductions will further these other goals or could do so without sacrificing the utility's opportunity to earn a reasonable return on its investment absent rate adjustments. This is particularly true when a utility is required to increase its commitment to programs that produce significant customer and public benefits, but that entail additional costs and may reduce sales and earnings.

Moreover, as phrased, the question assumes that utilities are not encouraged to maintain "management efficiency" under the current regulatory framework, which is simply not true. Any discussion of this issue should thus be broadened to examine the incentives and disincentives for maximizing "management efficiency" (once defined) and explore alternatives that may better align utility and customer interests.

In light of these comments, the Company therefore proposes that consideration of this question include a discussion of the incentives/disincentives that now exist under the current regulatory structure for a utility to minimize its cost of service, and whether that

structure can be modified in order to heighten the utility's incentive to minimize its cost of service while recognizing the utility's need to earn a reasonable return on equity, provide reliable service, and meet other customer and policy goals.

Question 8: Can incentives play a role in Arizona efficiently meeting its future utility infrastructure needs?

As noted earlier, any examination into whether the current regulatory framework motivates utilities to efficiently meet future infrastructure needs necessarily involves a broad examination of the disincentives existing in Arizona's current regulatory model and an evaluation of how that framework could be modified to eliminate those disincentives, rather than a narrowed focus on how limited financial incentive mechanisms might motivate such investment. To that end, the Company proposes inclusion of an examination of the incentives/disincentives now existing under the current regulatory framework that impact a utility's investment in Arizona's infrastructure needs, whether modifying that framework would be appropriate in light of those incentives/disincentives, and if so, how could/should that framework be modified.

Question 9: Should the Commission consider "decoupling" mechanisms for electric and gas companies? If so, what type of decoupling?

APS agrees that the Commission should assess the relative advantages and disadvantages of decoupling mechanisms (compared to other alternative regulatory mechanisms) as part of an overall inquiry into utility incentives for demand-side management, renewables, distributed generation, or other public policy programs. To broaden the inquiry, the query might additionally include a consideration of what cost-recovery mechanisms, if any, should be considered along with decoupling.

Question 10: Can the regulatory incentive structure be altered to change the stakes for a utility making a build or buy decision or other infrastructure decision?

This question suggests two things: (1) that there is a current regulatory "incentive" structure in place (as opposed to a "lack of incentive" in the current framework to make the required investment), and (2) that such "incentive" structure is the only factor in a utility's decision whether to build or buy, that it should apply to all resource decisions, and that the stakes should be changed in order to uniformly impact that decision. The Company agrees that this is an important issue to discuss and consider in this docket, but suggests that the question be broadened in order to capture all relevant issues. A broader inquiry should include a discussion of (1) the factors affecting a utility's decision regarding whether to build or buy or make other infrastructure investment decisions, (2) the incentives, disincentives or procedural/policy hurdles now existing under the current regulatory framework that impact such decision-making, and (3) whether modifying that framework would be appropriate, and, if so, how could/should that framework be modified to ensure that the utility has an incentive to choose the resource options that provide the best value to customers, taking into account their respective potential costs and benefits. Additionally, in some states such as

California, there are incentive mechanisms to encourage utility development of renewable generation. This inquiry could include consideration of that or similar issues.

Question 11: What impact does the current regulatory structure regarding the buy-or-build scenario have on competitive bidding as a tool in resource selection?

This question is closely linked to Question 10, and might appropriately be included in the discussions relative to that issue. From the Company's perspective, the issue is not whether or not competitive bidding should be used, but in what form and under what procedures will competitive bidding obtain the best results for customers and the Company, and how can (or should) the current regulatory model (including all policies and processes) be adapted to support such procedures.

Question 12: What are the best practices across the nation regarding regulatory incentives?

APS strongly supports this inquiry; however, it cautions that what might be "best" for, say, a gas utility in Michigan may not be "best" for the regulation of an electric utility in Arizona. Clearly, however, consideration of what regulatory options are working around the United States is important to this investigation.

Question 13: Are there any other specific topics that should be covered in the inquiry?

The Company agrees that it is appropriate to address other specific topics as they may emerge as the discussions relative to the preceding topics progress. In many cases, as APS has noted in these comments, additional topics can be associated with one of the existing questions in this investigative framework.

Question 14: Are there any legal impediments?

Given the somewhat unique legal landscape in Arizona as requiring that ratemaking be tied to a determination of fair value rate base, APS agrees that this is an important issue for evaluation. However, to avoid any confusion that any current legal impediments are irresolvable, the Company would broaden the question to read as follows: "Are there any legal impediments to any of the alternative regulatory structures identified that cannot be overcome?"

Comments Related to Process

In addition to its comments on the scope and questions for consideration, APS believes that the process used to advance this docket will be critical to ensure that the Commission's objectives, as articulated in Mr. Johnson's August 1, 2008 letter, are met through this investigation. Accordingly, APS recommends that in addition to the scope of the inquiry, the methods of inquiry be considered and discussed. Such methods could include additional written comments, reports, workshops and informal stakeholder

meetings. APS also believes that it would be helpful to identify the possible outcomes that are anticipated from this investigatory docket, such as potential new rules or rule changes, changes to formal or informal Commission policies, or the development of a record that could be used in other proceedings. Such considerations would significantly clarify both the process and the outcomes of this docket and facilitate full and effective participation from interested stakeholders.

Conclusion

The Company reiterates its keen interest in participating fully in this proceeding, which, APS believes, provides a good opportunity to re-examine the current regulatory framework in light of Arizona's changing energy landscape and determine how that structure can be adapted to facilitate and achieve important policy goals. The Company looks forward to participating in the substantive discussions regarding these queries, and to working with the Commission and interested stakeholders on policy solutions to the critical issues that will be explored in this investigation.