Leland R. Snook
Director
State Regulation & Pricing

Tel. 602-250-3730
Fax 602-250-3003
e-mail Leland.Snook@aps.com

Mail Station 9708
PO Box 53999
Phoenix, Arizona 85072-3999

April 15, 2009 ORIGINAL

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

RE: ENERGY EFFICIENCY TECHNICAL WORKING GROUPS
ARIZONA PUBLIC SERVICE COMPANY'S RESPONSES TO STAFF QUESTIONS
DOCKET NOs. E-00000J-08-0314 and G-00000C-08-0314

On April 1, 2009, Commission Staff issued a letter requesting that interested parties provide written responses to questions that will be discussed at the Energy Efficiency Technical Working Group meetings. Staff indicated that the questions should be answered assuming an energy efficiency goal of at least 20% of the total energy resources needed to meet retail load in 2020. Enclosed are Arizona Public Service Company's general comments and responses to Staff' questions.

If you have any questions or concerns, please call me at 602-250-3730.

Sincerely,

Leland R. Snook

Attachment

LRS/dst

Cc: Ernest Johnson
Brian Bozzo
Terri Ford
Barbara Keene
Parties of Record

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COPY of the foregoing was mailed or emailed this 15th day of April, 2009, to:

Lawrence V. Robertson, Jr.
P.O. Box 1488
Tubac, AZ 85646

Tim Hogan
Arizona Center for Law in the Public Interest
202 East McDowell Road
Suite 153
Phoenix, AZ 85004

C. Webb Crockett
Patrick J. Black
Fennemore Craig
3003 North Central, Suite 2600
Phoenix, AZ 85012-2913

Jodi Jerich
Daniel Pozefsky
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007

Michael A. Curtis
William P. Sullivan
Larry K. Udall
Curtis, Goodwin, Sullivan, Udall & Schwab, P.L.C.
501 E. Thomas Road
Phoenix, AZ 85012-3205

Jay I Moyes
Karen Nally
Moyes Storey LTD
1850 N. Central Ave, Suite 1100
Phoenix, AZ 85004

Gary Yaquinto
President & CEO
Arizona Utility Investors Association
2100 N. Central Avenue, Suite 210
Phoenix, AZ 85004

Michael M. Grant
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, AZ 85016
Attorneys for AIC

Lyn A. Farmer
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

Janice Alward
Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

Ernest G. Johnson
Director
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

Michael Kurtz
Kurt J. Boehm
BOEHM, KURTZ & LOWRY
36 E. Seventh Street, Suite 2110
Cincinnati, OH 45202

Creden Huber
Sulphur Springs Valley Electric Cooperative, Inc
P.O. Box 820
Wilcox, AZ 82311

Ladel Laub
Dixie-Escalante Rural Electric Association, Inc
71 East Highway 56
Beryl, UT 84714-5197

Carl Albrecht
Garkane Energy Cooperative, Inc
P.O. Box 465
Loa, UT 84747

Jeffrey Woner
K.R. Saline & Associates, PLC
160 N. Pasadena, Suite 101
Mesa, AZ 85201

Richard Adkerson
Ajo Improvement Company
P.O. Drawer 9
Ajo, AZ 85321

Jack Shilling
Duncan Valley Electric Cooperative's Gas Division
P.O. Box 440
Duncan, AZ 85534-0440

Dennis True
Morenci Water and Electric Company
P.O. Box 68
Morenci, AZ 85540

Douglas Mann
Semstream Arizona Propane, LLC
200 W. Longhorn
Payson, AZ 85541

Russ Barney
Graham County Utilities, Inc
P.O. Drawer B
Pima, AZ 85543

Gray Grim
Arizona Electric Power Cooperative, Inc
P.O. Box 670
Benson, AZ 85602

David Western
Trico Electric Cooperative, Inc
P.O. Box 930
Marana, AZ 85653

Paul O'Dair
Navopache Electric Cooperative Inc
1878 W. White Mtn Blvd
Lakeside, AZ 85929

Scott Canty
The Hopi Tribe
P.O. Box 123
Kykotsmovi, AZ 86039

Marcus Middleton
Copper Market, Inc.
P.O. Box 245
Bagdad, AZ 86321

Paul Griffes
Mohave Electric Cooperative, Inc
P.O. Box 1045
Bullhead City, AZ 86430

Michael Fletcher
Columbus Electric Cooperative, Inc
P.O. Box 631
Deming, New Mexico 88031

David Couture
UNS Electric, Inc
P.O. Box 711
MS UE201
Tucson, AZ 85702

Randy Sable
Southwest Gas Corporation
MS LVB-105
5241 Spring Mountain Road
Las Vegas, NV 89150

Justin Brown
Southwest Gas Corporation
MS LVA-120
5241 Spring Mountain Road
Las Vegas, NV 89150

Brooks Congdon
Southwest Gas Corporation
MS LVB-100
5241 Spring Mountain Road
Las Vegas, NV 89150

Laura Sanchez
NRDC
1500 Lomas Blvd. NW, Suite B
Albuquerque, NM 87104

John Wallace
GCSECA
120 North 44th Street, Suite 100
Phoenix, AZ 85034

Jeff Schlegel
SWEEP
1167 W. Samalayuca Drive
Tucson, AZ 85704

Mona Tierney-Loyd
EnerNOC, Inc.
P.O. Box 378
Cayucos, CA 93430

Michael W. Patten
ROSHKA, DeWULF, & PATTEN PLLC
One AZ Center
400 E. Van Buren, Suite 800
Phoenix, AZ 85012

Raymond Heyman
Unisource Energy
One S. Church, Suite 200
Tucson, AZ 85701

David Berry
Western Resources
P.O. Box 1064
Scottsdale, AZ 85252-1064

Energy Efficiency Technical Working Groups
Docket Nos. E-00000J-08-0314 and G-00000C-08-0314
Arizona Public Service Company's Responses to Staff Questions
April 15, 2009

On April 1, 2009, Commission Staff issued a letter requesting that interested parties provide written responses to questions that will be discussed at the Energy Efficiency Technical Working Group meetings. Staff indicated that the questions should be answered assuming an energy efficiency goal of at least 20% of the total energy resources needed to meet retail load in 2020. Arizona Public Service Company' ("APS" or "Company") general comments and responses to specific questions are provided below.

Overview

APS believes that achieving the stated goal of "at least 20% of the total energy resources needed to meet retail load in 2020" must come from a combination of both utility Demand Side Management ("DSM") programs, and changes in building codes and appliance energy efficiency standards. These two approaches work in tandem and both achieve the same objective of reducing energy usage in homes and businesses and, therefore, both should be contributors to meeting the stated goal.

Energy savings from utility DSM programs are measured by comparing the energy use of high efficiency equipment and building practices to "standard" equipment and practices, as defined by current building codes and appliance efficiency standards. As the building codes and appliance standards are improved over time by federal or state legislation, there may be less opportunity for savings from utility-sponsored DSM programs beyond the new, improved "standards". Therefore, APS believes that any energy efficiency goal that is being considered for Arizona should acknowledge that both utility DSM programs and changes in building codes and appliance standards contribute to achieving the goal.

As part of its resource planning process, APS analyzed several energy efficiency scenarios as documented in the "2009 Resource Plan Report", which was filed on January 29, 2009 (Docket No. E-01345A-09-0037). The energy efficiency scenarios were based on APS' Market Potential Study, which was completed by ICF International in 2007 and filed on September 12, 2007 (Docket No. E-01345A-05-0182). The scenarios in the Resource Plan ranged from 4% to 15% of load by 2025, and were compared with the long term economics of conventional generation resources in a consistent manner. These were further evaluated under a variety of scenarios relating to natural gas prices, carbon legislation, and the cost of implementing energy efficiency measures. Under the baseline conditions, the "optimum" amount of energy efficiency was found to be about 7% of load by 2025. Under high gas price, high carbon price, or low cost of energy efficiency measure scenarios, it was found that up to 15% of load by 2025 may be economically justified.

Having said that, and recognizing that there are many unknowns involved in estimating the long term economics of energy efficiency, APS can support an energy efficiency goal

of 20% by 2020 provided that adequate funding and adjustment mechanisms are in place so that the appropriate adjustments can be made to the targets based upon new developments and information learned through the implementation process. The 20% savings goal by 2020 should consist of 15% savings from utility DSM programs and 5% from changes in building codes and appliance efficiency standards over a stated base year level of efficiency. The base year should be set at standard efficiency levels that were in place as of January1, 2009. Future changes in building codes and appliance efficiency standards above the 2009 level should be counted toward the 5% "codes and standards" portion of the energy efficiency goal, and utility DSM program savings should be measured against the improved building codes and standards that are in effect at the time the high efficiency equipment is installed. These program savings would contribute to the 15% utility program portion of the goal. Should building codes and appliances standards be improved significantly prior to 2020, then the resulting energy savings may be greater than 5% from "codes and standards" and the resulting utility program savings may be less than the original goal of 15%.

In addition, the Company believes that any energy efficiency goal or plan should have sufficient "off-ramps" built into the process to provide flexibility in implementing the plan, and to help manage the many risks that are inherent in a long range course of action. Such risks may include, for example, changes in energy efficiency from building codes and standards, changes in DSM program costs from forecasted levels, availability of DSM resources due to, for example, changes in customer acceptance of DSM programs, and funding requirements of DSM program costs and other associated revenue requirements. These off-ramps would allow the Commission to address these risks by reconsidering or adjusting the goal if necessary.

Finally, the Company acknowledges that there are many data sources, assumptions and methods and models used in estimating program costs, kWh savings from energy efficiency, impacts on peak demand, avoided generation and transmission costs, unrecovered fixed costs, customer bill impacts and other related analysis. Therefore, the Company recommends that the Technical Working Group discuss the details of these types of computations to ensure that information from the various parties is relatively consistent and can be compared on an "apples-to-apples" basis.

Q1. What should the annual percentage be and on what schedule?

APS believes that all energy savings from the Company's DSM programs since 2005 should be counted toward the goal of 15% by 2020. Through the end of 2008, approximately 565,000 MWh have been saved through APS's DSM programs, or about 1.8% of 2008 total retail sales. APS anticipates savings of approximately 265,000 net MWh in 2009, given the current Commission-approved budget of $25.5 million for the year. This level of savings in 2009 will bring the cumulative savings since 2005 to approximately 830,000 MWh through the end of 2009, which should be counted toward the goal.

APS suggests the following annual targets, beginning in 2010, to meet the standard of 15% by 2020. These annual targets provide a necessary ramp-up period in 2010 and 2011 from current levels, level off to 1.5% per year from 2012 to 2016, and then maintain a constant 560,000 MWh savings per year from 2016 to 2020. The cumulative impact is approximately 6,400,000 MWh of savings in 2020, which is estimated to be 15% of the forecasted retail energy resources in that year.

APS' Suggested Annual Targets
For Achieving 15% Energy Savings in 2020

Year	% Savings	Annual MWh Savings (1)	Cumulative MWh Savings (2)
2005-2009			830,000
2010	1.00%	320,000	1,150,000
2011	1.25%	400,000	1,550,000
2012	1.50%	490,000	2,040,000
2013	1.50%	500,000	2,540,000
2014	1.50%	520,000	3,060,000
2015	1.50%	540,000	3,600,000
2016	1.50%	560,000	4,160,000
2017	1.45%	560,000	4,720,000
2018	1.40%	560,000	5,280,000
2019	1.35%	560,000	5,840,000
2020	1.30%	560,000	6,400,000

Notes:
1. Annual Saving depicts the additional MWh from new DSM measures installed in that year.
2. Cumulative Saving depicts the total DSM impact in that year.
3. This schedule for annual targets will result in 15% cumulative savings from utility-sponsored programs by 2020.

Q2. What are the estimated annual costs of achieving this goal?

The Company believes that there is much uncertainty inherent in forecasting future costs of DSM, particularly since those costs are subject to many factors beyond the utility's control, including economic business cycles and the way that customers will respond to future programs and technology advances. However, it is commonly understood that as the most cost effective measures are adopted, the "low hanging fruit" becomes exhausted first, and then more costly DSM measures are required to meet the goal. And as goals become more aggressive, the program design needs to become more aggressive to meet the goal. For instance, APS may have to pay incentives up to 100% of a customer's incremental cost (or more) to purchase more efficient measures in order to attract sufficient customer participation to achieve aggressive savings targets. And program advertising and marketing efforts will need to expand to attract more participation. All of these factors will likely increase DSM program costs per kWh saved in the future. Based on APS' Market Potential study, costs to achieve the utility's share of the 20% energy

efficiency goal by 2020 could range from $24 million in 2010 to as high as $350 million per year in 2020, above APS' current DSM spending level.

APS acknowledges that these costs are very uncertain, and could turn out to be substantially different (either lower or higher) than projected. Actual costs and customer participation will become more predictable over the next few years as we develop and implement increasing amounts of energy efficiency programs. Estimated program costs and performance incentives are provided for three representative years – 2010, 2015, and 2020 in Exhibit A.

Q3. What would be an estimate of annual savings, in dollars, of achieving this goal?

Annual cost savings include the generation and transmission capacity and energy costs which are avoided as a result of the DSM programs. These savings vary each year depending on the level of DSM kWh savings, expected fuel costs, and the revenue requirements associated with deferred capacity. Estimates of these savings are provided for representative years – 2010, 2015, and 2020 in Exhibit A.

Q4. How and to what extent can energy efficiency help to relieve system constraints?

Implementation of energy efficiency programs will not only reduce APS's retail energy requirements, but will also reduce its peak load requirements. By reducing peak load, these programs will defer the addition of new generation facilities and their associated transmission requirements. APS analyzed the impacts of achieving 15% energy efficiency from utility programs by 2020 and found that nearly 900 MW of new conventional resources could be avoided/deferred by 2020 as compared to the status quo case.

Q5. What is an adequate level of funding?

Total funding requirements, which include program costs, performance incentives, and a rate making adjustment for unrecovered fixed costs, are provided for three representative years – 2010, 2015, and 2020 in Exhibit A.

Q6. What are the best methods of cost recovery?

APS believes that DSM program costs and performance incentives should be recovered through a combination of base rates and an adjustor mechanism. Furthermore, the Company believes that the adjustor mechanism should recover costs in the same year they are spent by basing the charge on projected DSM spending, with a true-up to actual spending and recoveries in the following year.

In addition, DSM costs are currently expensed, which means that the entire cost is reflected in the year it occurs, while the program benefits continue to accrue over time. In contrast, generation and transmission capacity costs, which are the alternative to DSM, are capitalized, resulting in revenue requirements reflected over the life of the asset. This results in a mismatch between the stream of DSM costs and the avoided generation and transmission capacity costs over time. The bill impacts from an expanded DSM program, which are provided in Exhibit A, illustrate this issue. Customers pay for the entire DSM program costs upfront, while the cost savings accrue over time. Therefore, the bill impacts for 2010 and 2015 are higher than for 2020, when the capacity savings "catch up" to the front loaded DSM program costs. As a result, APS recommends that consideration be given to the capitalization of DSM program costs to address this issue.

Q7. What would be the bill impacts to customers of achieving this goal?

The bill impacts would include the recovery of program costs, performance incentive, and unrecovered fixed costs net of the reduction in capacity and energy costs discussed in the response to question 3. The bill impacts would also include the reduced consumption from the DSM measures installed in customer's homes and businesses. Estimates of the net bill impacts are provided for residential and business customers for three representative years – 2010, 2015, and 2020 in Exhibit A. This information reflects the impact on average customers. Customers that participate in the DSM programs would likely see a lower bill impact than those reflected in Exhibit A due to the reduced consumption from implementing the DSM measures.

Q8. What waivers may be necessary for unexpected circumstances?

APS believes that predicting the market for DSM products, services, technologies, and potential future changes to building codes and standards more than 10 years into the future is subject to many assumptions. While a long range savings target is a worthwhile goal to establish, it should also be tempered with the reality that many unexpected circumstances could arise that would impact the ability to achieve the goals and the amount of funding that will be required. This will require some built in flexibility to allow for appropriate adjustments that may be needed in the future.

Given the difficulties in predicting future technologies and with the current uncertainties in the market, it would be wise to consider a process where savings targets are re-visited periodically (perhaps every 2-3 years) and adjusted as necessary to incorporate information about emerging technologies and their potential energy savings, changes in the costs of implementing DSM programs, information about current business cycles and changing needs for energy efficiency (whether higher or lower).

It is also essential to recognize that for utilities to achieve DSM savings, customers must be willing to invest their own money to install energy efficiency measures in their homes or businesses. Therefore, it is necessary to consider economic business cycles when

attempting to predict appropriate long term energy efficiency goals. For instance, APS has seen a noticeable decline in the fourth quarter of 2008 in DSM customer incentive requests, which we believe reflects the current economic slowdown. It appears that customers are unable or unwilling to participate in energy efficiency programs because they can not afford or are unwilling to make the initial investment in energy efficient equipment required, even with the customer incentives offered under the DSM programs. Similarly, there is lower savings potential from new construction with fewer new buildings being constructed in the current economic environment. Energy efficiency targets may simply be impossible to achieve under these economic conditions. As a result, any energy efficiency target that is developed should include flexibility to account for the fact that economic business cycles could impact the ability of a utility to meet the savings goal in any particular year.

In addition, savings goals must be adopted together with a policy that acknowledges the uncertainty of the funding that will be needed to achieve the target. If a savings goal is developed that is out of sync with DSM program funding required to meet the goal, it can result in an unachievable target or a significantly higher spending level that would have adverse near-term rate impacts on customers. It is unwise to set both a spending target and a savings target because having both would lock in a future price ($/MWh) for delivery of DSM. It would be preferable to set an energy efficiency target based on MWh savings goals, and have an estimate of the dollars that would be needed to achieve it. In this case, the spending target would no longer be a "goal", but simply an estimate of the funding that may be necessary to reach the savings goal. This would require much more DSM program budget flexibility than current Commission policy provides. Some type of revised policy should be established to provide for this necessary funding flexibility, which could include an "off-ramp" or ability to adjust the target if costs escalate beyond a set parameter.

It is also clear that some policy modifications would be necessary to streamline the current program approval and regulatory oversight process to make the energy efficiency savings goals achievable in any given year. For instance, the current lag time between DSM program filing and approval, which can be more than one year, would need to be substantially reduced. This could be accomplished in part by addressing the inefficiencies inherent in having utilities and Commission Staff both conduct separate benefit/cost tests to prove the cost effectiveness of programs. Utilities should also be given broader flexibility to adjust individual program budgets and shift funds between program budgets to optimize the savings achieved for the dollars spent. This would allow the utilities to better manage DSM budgets in various economic cycles.

Q9. What would be the revenue concerns, quantified, for utilities?

Because many of APS' fixed costs are recovered through volumetric charges, the sales reduction from DSM programs reduces the revenue recovery for fixed costs without any corresponding reduction in those costs. As a result, fixed costs are under recovered until rates are adjusted in the next rate case. An estimate of unrecovered fixed costs for the

assumed goal is provided in Exhibit A under the heading "Rate Making Adjustment." This estimate assumes that a rate case will take place every three years, and uncollected fixed costs would be reset to zero at that time.

Q10. What are the methods that should be used to address the revenue concerns of utilities?

APS believes that the uncollected fixed costs ("UFC") could be addressed in a variety of ways. For example, UFC could be addressed in the rate making process by using a future test year, adjusting test year kWh by the expected kWh reductions from DSM programs, or recovering more of the fixed costs through fixed charges. UFC could also be addressed by decoupling revenue, or revenue per customer, from DSM sales impacts, or by implementing some other type of annual rate adjustment which corrects for this deficiency in cost recovery. UFC could also be recovered through the DSM cost adjustment mechanism discussed above.

The issues of UFC can be illustrated with the following example, which demonstrates a similar mismatch to that which exists for the Company with respect to how costs are incurred and how they are recovered.

Ratemaking Impacts of Energy Efficiency

- Setting utility rates is a two step process:

  (1) Determine revenue requirement (essentially operating expenses plus a return on the capital investments made by the company); and

  (2) Design rates that collect that revenue requirement.

  Example: Assume revenue requirement is $1,000 and there are 10 customers who each use 1000 kWh. A rate of 10 cents per kWh would collect the $1,000 revenue requirement:

  1000 kWh * 10 customers * $0.10 = $1,000

- Energy efficiency results in lower sales, so it complicates the traditional ratemaking formula.

  Example: Assume 10 percent energy efficiency standard is implemented at the same time, so that these 10 customers will now only consume 900 kWh:

  900 kWh *10 customers * $0.10 = $900

- The results are that the utility under-recovers its revenue requirement using traditional ratemaking formula.

- This is further complicated by the fact that many "fixed costs" such as transformers, poles and wires are recovered through volumetric (kWh) charges:

  In the example above, energy efficiency may have saved the utility from spending $50 in fuel (variable) costs, but still results in a $50 revenue reduction needed to cover the transformers, poles and wires (fixed) costs.

  Example: This can be addressed by increasing the per kWh charge to recover the same revenue:

  900 kWh *10 customers * $0.11 approximately equals $1,000

APS believes that different ways to address this issue are appropriately discussed in the Technical Working Group workshops.

APS' SUMMARY OF DSM PROGRAM COSTS, AVOIDED COSTS, AND BILL IMPACTS
For 20% GOAL BY 2020

Incremental Changes over Current Level of DSM

	Estimated Cost Impacts ($000)	Avg. Residential Customer Monthly Bill Impact	% Change	Avg. Business Customer Monthly Bill Impact	% Change
2010					
Program Costs	$ 23,978	$ 0.848	0.8%	$ 6.124	0.7%
Performance Incentive Cost (Alternatives)					
(a) Meeting 85% of Target	$ 2,123	$ 0.075	0.1%	$ 0.541	0.1%
(b) Meeting Target	$ 3,747	$ 0.129	0.1%	$ 0.933	0.1%
(c) Exceeding Target	$ 5,372	$ 0.195	0.2%	$ 1.404	0.2%
Revenue Requirement Impacts					
Rate Making Adjustment	$ 8,923	$ 0.311	0.3%	$ 2.247	0.3%
Capital Expenditure Savings	$ -	$ -	0.0%	$ -	0.0%
Fuel & Purchase Power Savings	$ (24,513)	$ (0.870)	-0.8%	$ (6.278)	-0.8%
Total Incremental Bill Impact					
With Perf. Inc. @ 85% of Target	$ 10,510	$ 0.364	0.3%	$ 2.634	0.3%
With Perf. Inc. @ Meeting Target	$ 12,135	$ 0.419	0.4%	$ 3.026	0.4%
With Perf. Inc. @ Exceeding Target	$ 13,759	$ 0.484	0.4%	$ 3.497	0.4%
2015					
Program Costs	$ 263,386	$ 8.257	7.7%	$ 57.592	7.6%
Performance Incentive Cost (Alternatives)					
(a) Meeting 85% of Target	$ 26,117	$ 0.824	0.8%	$ 5.750	0.8%
(b) Meeting Target	$ 35,560	$ 1.118	1.0%	$ 7.797	1.0%
(c) Exceeding Target	$ 45,003	$ 1.411	1.3%	$ 9.845	1.3%
Revenue Requirement Impacts					
Rate Making Adjustment	$ 63,867	$ 2.003	1.9%	$ 13.972	1.8%
Capital Expenditure Savings	$ (22,627)	$ (0.708)	-0.7%	$ (4.941)	-0.7%
Fuel & Purchase Power Savings	$(141,936)	$ (4.453)	-4.2%	$ (31.060)	-4.1%
Total Incremental Bill Impact					
With Perf. Inc. @ 85% of Target	$ 188,808	$ 5.923	5.6%	$ 41.314	5.4%
With Perf. Inc. @ Meeting Target	$ 198,251	$ 6.216	5.8%	$ 43.361	5.7%
With Perf. Inc. @ Exceeding Target	$ 207,694	$ 6.510	6.1%	$ 45.408	6.0%
2020					
Program Costs	$ 348,456	$ 9.345	9.0%	$ 63.714	8.8%
Performance Incentive Cost (Alternatives)					
(a) Meeting 85% of Target	$ 34,626	$ 0.937	0.9%	$ 6.389	0.9%
(b) Meeting Target	$ 46,899	$ 1.259	1.2%	$ 8.581	1.2%
(c) Exceeding Target	$ 59,172	$ 1.590	1.5%	$ 10.839	1.5%
Revenue Requirement Impacts					
Rate Making Adjustment	$ 44,947	$ 1.205	1.2%	$ 8.217	1.1%
Capital Expenditure Savings	$(127,005)	$ (3.409)	-3.3%	$ (23.244)	-3.2%
Fuel & Purchase Power Savings	$(261,688)	$ (7.032)	-6.7%	$ (47.948)	-6.6%
Total Incremental Bill Impact					
With Perf. Inc. @ 85% of Target	$ 39,337	$ 1.046	1.0%	$ 7.129	1.0%
With Perf. Inc. @ Meeting Target	$ 51,609	$ 1.367	1.3%	$ 9.320	1.3%
With Perf. Inc. @ Exceeding Target	$ 63,882	$ 1.698	1.6%	$ 11.578	1.6%