BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF COLORADO
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IN THE MATTER OF THE INVESTIGATION OF REGULATORY AND RATE INCENTIVES FOR GAS AND ELECTRIC UTILITIES	)))	**Docket No. 081-113EG**

COMMENTS OF PUBLIC SERVICE COMPANY OF COLORADO AS TO THE SCOPE OF THE PROCEEDING

I. PROCEDURAL BACKGROUND

In its In its *Order Opening Investigatory Docket and Notice of Inquiry* ("Investigatory Order") in Docket No. 08I-113EG, mailed April 29, 2008, the Colorado Public Utilities Commission ("Commission" or "CPUC") opened an investigation into the regulatory and rate incentives provided gas and electric utilities under the current regulatory approach, as well as under potential alternative approaches. In its Investigatory Order the Commission identified:

- ten issues for interested parties to explore during the investigation;
- various means of gathering information, such as workshops, informal meetings and written comments; and
- potential results or outcomes of the investigation, such as recommendations for rule changes, recommendations for legislative policy changes, or the development of a formal record that could be used in other Commission proceedings.

The Commission invited interested parties to submit comments by May 29, 2008, on the appropriate scope of the inquiry and the methods of inquiry. The comments of

Public Service Company of Colorado ("Public Service" or "the Company") are provided below.

II. OVERVIEW OF PUBLIC SERVICE COMMENTS

Public Service applauds the Commission for initiating this investigation and appreciates the opportunity to participate. The Company agrees that there is a critical need to evaluate the incentives provided to utilities under the current regulatory framework to determine if fresh approaches are warranted. Three factors in particular highlight the need for this investigation.

First, the Company projects the need for higher levels of capital investment to continue providing high-quality service to an increasing customer base in Colorado. We are currently experiencing increasing incremental costs, due in large part to significant increases in the costs of a variety of materials inputs ranging from copper to lime to transformers. In this environment, in which system needs and costs are climbing at the same time, a comprehensive mechanism that adequately addresses timely cost recovery and facilitates investments in infrastructure becomes even more critical.

Second, over the past several years the State of Colorado has begun the transition to a “New Energy Economy" that features an increased reliance on renewable energy, energy efficiency, more sophisticated pricing, and better protection of customers least able to afford service. Achieving these worthy goals requires a transformation of the utility mission. Specifically, the traditional goal of providing reliable utility service at least cost to customers is no longer sufficient. Colorado utilities must now place more emphasis on the consequences of their decisions on environmental quality, price risk and affordability. This shift in focus often leads to programs or resource decisions that may raise utility rates in the short term, but:

- reduce environmental impacts,
- reduce the risk of fuel-price increases,
- allow customers to receive the same level of service with less energy use,
- send better price signals, and/or
- ease the burden on low-income customers.

In effect, utilities are being asked to provide energy services at the most equitable, risk-adjusted social cost, rather than provide electricity and natural gas at the lowest private cost.

Third, the traditional practice in Colorado of using historical test years with no interim rate relief often imposes long lags between cost incurrence and the recovery of costs through rates. The resulting regulatory lag has profound impacts on utility incentives to make investments in needed infrastructure.

The first and second factors have resulted in higher levels of utility investments and expenses. Moreover, some of these costs are subject to significant variability from year to year. In the case of energy efficiency, the utility must also contend with the significant earnings erosion resulting from reduced customer use. The third factor jeopardizes both the timely recovery of these increased costs and the timeliness of rate adjustments to capture reductions in use per customer.

In response, the Company has sought ways to reduce the risk of incomplete or untimely cost recovery and address the earnings impacts of reduced customer use. These remedies include rate adjustment clauses (rate or bill riders) that allow for the complete and timely recovery of costs outside of rate cases, a partial gas decoupling mechanism, and the recovery of lost margins attributable to energy-efficiency programs.

Each of these various regulatory mechanisms and policies (either currently in effect or proposed) seemed reasonable when considered in isolation and in the context of the existing regulatory framework. But taken as a package, they arguably constitute a "patchwork of remedies that effectively expose some fundamental weaknesses in the current approach. This investigation should help the Commission assess how the current regulatory framework could be adapted to meet these new challenges in a manner that balances the interests of customers in efficiency, reliability, and a high level of customer service with the need for a financially healthy utility that can easily access capital markets to make investments that will serve the needs of customers both today and well into the future.

The Company stresses that any evaluation of utility incentives be reviewed not only from the perspective of the utility, but also from the perspective of the public-policy objectives that are being sought. While utility incentives directly benefit the utility, such incentives, such as those we proposed in the recent DSM proceeding, are also designed to align utility and consumer interests. An investigation that focuses only on incentives to the utility does not adequately recognize the potential benefits of alternative recovery mechanisms in terms of facilitating customer benefits. As such, the Commission should broaden its investigative scope to review how the various mechanisms affect customer interests, not just utility interests; the Commission should not presume that there is no potential for mutuality of interest. In fact, we believe that as the Commission moves forward with this investigation it will find, more often that not, that policies that encourage and strengthen the financial health of utilities are also in the long-term best interests of customers.

Finally, the Company notes that any evaluation of utility incentives should recognize differences among utilities. Colorado gas and electric utilities are subject to different public-policy and regulatory obligations – both in scope and magnitude – that affect the need for and impact of regulatory changes. The Company urges the Commission to remember these differences when evaluating and applying regulatory alternatives.

III. PUBLIC SERVICE SPECIFIC COMMENTS ON SCOPE OF PROCEEDING

Public Service believes that the Commission's preliminary list of 10 issues captures the key issues ripe for investigation. Consequently, the Company will focus its comments in this section on providing additional context for the 10 issues and suggesting limited revisions or additions. This narrative is intended to explain the reasons for changes in scope. While this discussion naturally touches upon some of the substance of any investigation, we hope that the Commission recognizes that issue scoping and the substance are by their nature intertwined. We ask only that the Commission accept these comments to inform its decision on the appropriate scope, as we are mindful of the admonition that the Commission is not seeking a substantive response.

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

Public Service suggests that the Commission devote a large share of its investigatory resources to this fundamental issue. The utility's incentive to pursue adjustment clauses is driven in large part by: (1) the test-year determination and the resulting regulatory lag; and (2) the magnitude and timing of significant new investments. We think that when the Commission evaluates the state of the art in other jurisdictions it will recognize that the financial recovery mechanisms adopted in the 1980s are no longer sufficient to obtain and attract capital in today's financial markets. Likewise, depreciation policies and the authorized return on equity drive the utility's incentive to either conserve capital or to expand its investments in the utility system. A thorough assessment of the impact of these fundamental regulatory policies on utility incentives is crucial.

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

The Company believes this issue should be reframed. The allowance of a reasonable return on rate base is only one factor, and arguably not the most important factor, in determining utility earnings and incentives. The broader issue is whether the State's current approach to basing rates on historic test-year revenue requirements (all prudently incurred expenses including a return on rate base) is optimal.

Two obvious alternatives to the traditional approach of basing rates on test-year costs and usage are price-cap regulation and performance-based regulation. (The financial incentives referenced in Issue v are a limited application of performance-based regulation.) But the current ratemaking approach could be modified in many ways without departing from the basic test-year model. For example, current and future test years could be used to determine revenue requirements. In addition, utilities could be required to file rate cases according to pre-established schedules, be authorized to adjust rates between rate cases though "make-whole" filings, or have the right to implement interim rates.

Based on this discussion the Company suggests the following language for Issue ii:

> ***What are the alternatives to setting rates based on a determination of test-year revenue requirements and billing determinants? What are the alternative approaches to implementing the traditional test-year approach to ratemaking? What incentives does each of the alternatives provide to utilities?***

This more broadly framed question will allow for the exploration of variations of today's current model, which has an important grounding in law and regulation. In short, by reframing the question we hope to create a dialogue around potential options without placing the utility or other stakeholders in the position of opposing refinements to the regulatory approach to avoid the risk of an uncertain outcome. This is particularly important when there may well be alternatives that would address the underlying concerns without fully displacing the current regulatory paradigm.

Issue iii: How do adjustment clauses affect utility incentives?

The Company suggests a slight expansion of the question. As indicated at the outset, the Commission inquiry should not be focused solely on utility incentives. The inquiry should be broad enough to evaluate whether certain adjustment clauses or riders also serve the broad public interest. By reducing risk and regulatory lag, adjustment clauses encourage utilities to devote resources to activities whose costs are recovered through such clauses.

This focus may benefit our customers significantly. A recent example is Public Service of New Mexico, which lacked a fuel adjustment clause and was subsequently downgraded to junk status. This downgrade triggered a request for emergency relief that was recently granted. In that case, the lack of an adjustment clause directly affected New Mexico's largest public utility's access to and cost of capital.

Thus we propose that the Commission investigate the following:

How do adjustment clauses affecf ufilify incentives and what fypes of adjustments or riders may either reduce overall customer costs or beffer align utility investor interests with state public-policy objectives.

*Issue **iv:** What are the alternatives **to** adjustment clauses?*

The Company agrees this is an important issue, and one that is closely linked to Issues i, ii and iii. In fact, by effectively addressing the first three issues the Commission may resolve Issue iv. Again, the Commission should consider whether the alternatives considered achieve public-policy objectives more effectively than adjustment clauses and riders. Thus, the Company suggests the following addition to Issue iv:

What are the alfernatives to adjusfment clauses? What are their relative advantages and disadvantages?

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

Issue 5 is critical to the successful transition to a New Energy Economy. The record in Docket No. 07A-420E confirms that the utility's financial incentives can be aligned with the goal of encouraging effective utility-sponsored energy-efficiency programs. The Company suggests that the proposed evaluation of financial incentives be modified as follows to include additional public-benefit programs or initiatives:

Can the regulatory incentive structure be changed to align a utility's financial incenfives with the effective implementation of energy-efficiency programs, load-management programs, dynamic-pricing initiatives, initiatives to encourage distributed generation, and voluntary green-power programs?

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

If the Commission wishes to address this issue, then "management efficiency" needs to be defined or placed in the appropriate context. Reducing total costs per unit of service (e.g., lowering the total cost per MWh or decatherm provided or total cost per customer served) is a worthy goal, but it is not the only goal sought to be achieved through cost-of-service regulation. The goal of reducing costs needs to be balanced against other state policy goals. Examples of other worthy goals are system reliability, a high level of service quality, environmental protection, and the ability of the utility to make investments that provide long-term benefits to its customers and the state's economy. In an increasing-cost environment it is doubtful that such efficiency gains can allow utilities to earn a reasonable rate of return absent rate adjustments. This is particularly true when a utility is asked to increase its commitment to programs that produce significant customer and public benefits, but entail additional costs and may reduce sales and earnings.

Based on these considerations, the Company suggests that Issue vi be reworded as follows:

*Can the incentive structure be modified 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 **public-**policy goals?*

Issue vii: Should the Commission consider an electric "decoupling" mechanism?

Public Service agrees that decoupling is a policy option that merits careful consideration, and suggests that the Commission expand its investigation to include gas decoupling. Currently, only Public Service has a gas decoupling mechanism, which the Commission approved on a trial basis. This mechanism is limited to one class and captures only a portion of the revenue impacts of changes in weather-normalized sales per customer. Given this limited experience with gas decoupling to date, the Company believes that the Commission should consider whether additional or more comprehensive gas decoupling mechanisms are warranted and, if so, under what conditions.

Based on these considerations, the Company suggests that Issue vii be modified as follows:

> ***Should the Commission consider "decoupling" mechanisms for gas and electric utilities?***

Issue viii: Can the regulatory incentive structure be altered to change the stakes for a utility making a build-or-buy decision?

This critical issue has been developed in other proceedings, most notably in the Company's Colorado Resource Plan ("CRP") proceeding. The Commission has recognized an overlap between this investigation and various ongoing proceedings, and we note that we will continue to pursue these questions in other dockets as well. Nonetheless, this investigation provides a good opportunity to explore further the "build-versus-buy" issue.

As Public Service has discussed in its resource planning dockets, using power purchase agreements to acquire generation resources has adverse impacts on the utility and our customers that to date have not been fully quantified in the resource selection evaluations. The actions by credit rating agencies to "impute" debt and interest expense from power purchase agreements when calculating utility financial ratios impact both utility shareholders and utility customers. The accounting rules that will require the classification of some power purchase agreements as capital leases on utility financial statements will have a stronger, more adverse, impact on the utility's financial stability and cost of capital. These "hidden costs" are real and not within the control of the utility or this Commission. In the aggregate, these hidden costs can cause serious problems. In Docket No. 07A-447E, Public Service is suggesting ways that these issues can be addressed.

In addition to the debt and interest costs that the utility must reflect when it acquires resources through power purchase agreements, there are benefits associated with owning generation assets, instead of "renting" generation assets, that are difficult to quantify and incorporate into expansion plan modeling. As has been discussed in numerous Public Service dockets, utilities and their customers lose the benefits of a depreciated but still productive generation asset at the end of the PPA term, and it is very unclear whether the utility and the customers have received a discount on the power supplied under the PPA that compensates for that lost benefit. The Commission has framed this issue to suggest that rate base regulation is skewing utility decisions against power purchase agreements. Public Service suggests that there is a corresponding skewing in the opposite direction in Commission resource planning rules, which favor PPAs over utility rate-based units because the "all source" bidding that selects resources using a modeled net present value of revenue requirements fails to adequately reflect all the hidden costs of the PPAs and all of the hard-to-quantify benefits of utility-owned generation.

Public Service believes it is wise to adopt a diversified "portfolio" approach to resource acquisition to manage the risks inherent in each of the forms of generation ownership. This portfolio approach would recognize that there are advantages and disadvantages to both utility rate-based ownership and PPAs, and therefore utilities should have both owned units and PPAs in its diversified portfolio. Consequently, Public Service suggests that Issue viii be reworded as follows:

> ***Can the regulatory structure be altered such that the utility has a clear incentive to choose the resource options that provide the best value to customers, taking into account the potential costs and benefits of various resource options?***

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

Issue ix is closely linked to Issue viii. Once the utility has a clear incentive to choose the best value options, or an appropriate mix of owned and leased resources, then the utility and Commission can fashion competitive bidding processes that can be used to obtain the diversified portfolios. As Public Service explained in its testimony in Docket No. 07A-447E, the Company proposes to use competitive acquisition processes to obtain rate-based resources. The issue is not whether or not competitive bidding should be used; the real issue is what forms of competitive bidding should be used to obtain the appropriate diversified generation portfolio.

The other important issue is whether there is any sense in retaining the framework of "all source" bidding. For many years, Public Service and other intervening parties have been recommending that the Commission allow the use of targeted bidding in lieu of all-source bidding. Targeted bidding is the better process for obtaining the best results for achieving public policy goals of greater use of demand-side management, demand reduction, renewable resources, and carbon reduction. All source bidding made sense when the primary criterion for resource selection was price. The General Assembly, the Commission, and Public Service and other utilities have all recognized the need to incorporate factors other than price in resource selection. The best way to achieve these public policy goals is to use targeted bidding.

Given this background, the Company suggests that Issue ix be recast as follows:

> *Should the Commission retain "all source" bidding as the primary means of electric utility resource acquisition? What forms of competitive acquisition can be employed to acquire the types of generation resources that are determined to be in the public interest? How can competitive procurement be used for acquiring both utility-owned resources and power purchase agreements? What impact would the alternative regulatory* ***structure(s)*** *identified in response to Issue viii have on* ***the*** *efficacy of competitive bidding as tool in resource selection? Are there other processes in addition to competitive bidding that could or should be considered for the acquisition of utility generating resources?*

Issue ***x.*** *What is the state of* ***the*** *art across the nation?*

Public Service supports this research and does not recommend any changes to the wording of this issue.

IV. PUBLIC SERVICE COMMENTS ON METHODS OF INQUIRY

In its Investigatory Order the Commission noted that it would gather information through workshops, informal meetings, written comments, and other vehicles. The Company agrees that an emphasis on more collaborative, informal approaches should maximize the Commission's flexibility and the quality of the investigation. Nonetheless, the investigation should be conducted in a manner that preserves all parties' due process rights. At some point interested parties must provide written comments that set forth their recommendations and the bases for their recommendations, and all other parties should have the opportunity to respond in writing. A written report from the Commission Staff summarizing the results of the investigation should also be provided to all parties. Without such documentation, the analyses and conclusions of the investigation may be subject to considerable debate among parties.

Finally, while all commenters have a stake in how electric and gas utilities are regulated, the utilities themselves, and their shareholders, clearly have the greatest stake if there are fundamental changes in how they are regulated. Whatever processes are adopted by the Commission in this docket, the utilities must be afforded the opportunity to respond to any and all proposals made by other parties.

V. CONCLUSION

Public Service reiterates its appreciation for the opportunity to participate in this proceeding. We believe that the provision of positive utility incentives can facilitate the achievement of important public-policy goals. We look forward to working with the

Commission and interested stakeholders on policy solutions to the critical issues to be explored in this investigation.

Dated this 29th day of May, **2008.**

Respectfully submitted,

By: ____________________________

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<u>CERTIFICATE OF SERVICE</u>

081-113EG

I hereby certify that on this, the 29th day of May 2008, an original and ten (10) copies of the foregoing **COMMENTS OF PUBLIC SERVICE COMPANY OF COLORADO AS TO THE SCOPE OF THE PROCEEDING** were served via hand delivery on:

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