STANDARD &POOR'S | RATINGSDIRECT

Return to Regular Format

Research:

Fuel and Power Adjusters Underpin Post-Crisis Credit Quality of Western Utilities

Publication date: 14-Oct-2004

Primary Credit Analyst(s): Anne Selting, San Francisco (1) 415-371-5009; anne_selting@standardandpoors.com

It has been more than three years since the California energy crisis led to the rapid deterioration of credit quality for many western electric utilities. The financial distress that visited public power and investor-owned utilities (IOU) was in part attributable to the absence of fuel and purchased-power adjustment mechanisms (FPPA), coupled with a reliance on the wholesale market for significant supplies. It is not an oversimplification to say that IOUs that emerged relatively unharmed from the energy crisis benefited substantially from FPPAs, while those that suffered the most did not have FPPAs.

The severe market distortions of the California crisis have faded, but FPPAs continue to play a significant role in the financial well-being of western electric utilities. Natural gas volatility, poor hydro conditions in the Northwest, the Southwest's sustained drought, and uncertainty over future generation development are daily reminders that it is increasingly difficult for utilities to sustain their financial health solely through the use of hedging policies and regular general rate case filings. This article examines the progress by major western utilities in instituting FPPAs since the California crisis and comments on FPPA attributes that are important for credit quality.

What is an FPPA?

The overwhelming majority of a utility's expenses are concentrated in two categories--purchased power and fuel. Electric utilities that have the greatest exposure to significant cost swings are those that have sizable gas-fired generation and rely on power purchases that are indexed to market prices. Table 1 illustrates the proportion of 2003 expenses devoted to these two items for 12 western IOUs, and provides a measure of the dependence on gas and power purchases to meet load requirements.

Table 1 Largest IOUs in the West Without Fuel and Purchased-Power Adjusters

	Total fuel expenses (Mil. $) in 2003	Total purchased power expenses (Mil. $) in 2003	Percent of total expenses that is fuel and purchased power	Percent of retail sales supplied with own generation*	Percent of MWh from owned gas generation¶
Puget Sound Energy Inc.	65	649	35.2**	35.6	11.1
Avista Utilities/Avista Corp.	36	148	17.6**	73.8	7.4
Idaho Power/IDACORP Inc.	100	151	35.1	100.6	0.3§
Arizona Public Service/Pinnacle West Capital Corp.	703§§		36.1¶¶	84.5	4.9
Tucson Electric Power/UniSource Energy Corp.	210	65	34.4	136.9	4.0
PacifiCorp/PacifiCorp Holdings Inc.	482	1,213	50.5	107.7	4.1
Nevada Power Co./Sierra Pacific Resources	320	744	60.3	54.6	42.8
Sierra Pacific Power/Sierra Pacific Resources	321	745	53.1**	47.0	59.6
Portland General Electric Co.	1,028§§		60.2	43.0	17.3§

Public Service Co. of New Mexico	141	803	67.3**	134.4	2.1§
Southern California Edison Co.	235	2,786	39.2	63.7	-
Pacific Gas & Electric Co.	0	2,319	70.4**	36.0	1.7§

*Based on data provided by Platt's. ¶Based on company 10K filings, except where indicated by §, in which case data is provided by Platt's. **Combined utility (gas and electric). ¶¶Includes trading and marketing operations. §§Arizona Public Service and Portland General Electric fuel and power expenses are not separately broken out.

An FPPA allows utilities to automatically flow through retail rates any changes in fuel and purchased-power costs. An FPPA circumvents the need for a utility to file a formal rate case to adjust retail rates to reflect changes in these costs, and significantly increases the probability that an IOU will collect fuel and power costs from ratepayers in full and on a much more timely basis. This is accomplished typically through monthly tracking of costs, with periodic true-ups of a utility's forecast versus actual fuel and power costs, typically annually.

Which Western IOUs Have Instituted FPPA?

In 2000, the largest IOUs in the western U.S. did not have FPPA, and their credit ratings generally suffered as a result of the market disruptions that occurred beginning in 2001 (See table 2) Today, the majority of western utilities have some form of FPPA.

Table 2 Fuel and Purchased-Power Adjusters

Utility/Holding Company	2000 Rating	FPPA in 2000?	2004 Rating	FPPA in 2004?
Puget Sound Energy Inc.	BBB+/Negative/A-2	No	BBB-/Positive/A-3	Yes
Avista Utilities/Avista Corp.	BBB/Negative/--	No	BB+/Stable/--	Yes
Idaho Power/IDACORP Inc.	A+/Stable/A-1	Yes	A-/Watch Neg/A-2	Yes
Arizona Public Service/Pinnacle West Capital Corp.	BBB+/Stable/A-2	No	BBB/Negative/A-2	No
Tucson Electric Power/UniSource Energy Corp.	BB/Stable/--	No	BB/Watch Neg/--	No
PacifiCorp/PacifiCorp Holdings Inc.	A/Stable/A-1	No	A-/Stable/A-2	No
Nevada Power Co. and Sierra Pacific Power/Sierra Pacific Resources	BBB+/Watch Neg/A-2	No	B+/Negative/--	Yes
Portland General Electric Co.	A/Watch Neg/A-1	No	BBB+/Watch Neg/A-2	Quasi
Public Service Co. of New Mexico	BBB-/Watch Neg	No	BBB/Stable/A-2	No
Southern California Edison Co.	A+/Watch Neg/A-1	No	BBB/Stable/A-2	Yes
Pacific Gas & Electric Co.	A+/Watch Neg/A-1	No	BBB-/Stable/--	Yes

Indeed, of the utilities surveyed by Standard & Poor's for this article, four companies have not implemented FPPA-- PacifiCorp (A-/Stable/A-2), Tucson Electric Power Co. (BB-/Watch Neg/--), Arizona Public Service Co. (APS; BBB/Negative/A-2), and Public Service Co. of New Mexico (BBB/Stable/A-2).

PacifiCorp serves portions of Utah, Oregon, Wyoming, Washington, Idaho, and California, has no FPPA in any of these states, and was adversely affected by the California crisis. As a result of an extended coal plant outage and overall reliance on the market for a portion of its power requirements, PacifiCorp deferred $537 million in power costs in 2001 and 2002, of which only $303 million were ultimately authorized for recovery, with Wyoming disallowing the bulk of this difference. As a result of this exposure, PacifiCorp's outlook was revised to negative, and the company was only recently returned to stable. While PacifiCorp has sought an FPPA in Wyoming, the Wyoming Public Service Commission has rejected its request, but did recently approve a settlement resulting from the company's July 2004 filing to increase rates due to rising wholesale power costs. Because about 21% of PacifiCorp's power in 2003 came from purchases, the lack of an FPPA is a credit concern.

In Arizona, the Arizona Corporation Commission (ACC) is allowed to authorize FPPA, but APS' and

Tucson Electric Power's were discontinued in the 1980s. As part of a settlement pending before the ACC, APS has negotiated an FPPA, which it requested in its June 2003 rate case filing. It is unclear whether the ACC will ultimately authorize one. APS' exposure to fuel and purchased-power is significant. In 2002, the ACC halted restructuring of the state's wholesale generation market. While it ordered APS not to sell its generation, APS was uncertain as to how it would procure power to meet retail loads. With electric sales rising about 4% per year, the utility estimates that by the summer of 2007, it will require a nearly 1,200 MW of new capacity, at least a portion of which is likely to be power purchases at indexed prices. Because of APS' significant short position in coming years, an FPPA could lower the utility's risk profile.

Since July 2000, Tucson Electric Power has been under a rate freeze that ends in 2008. Upward movement in gas or purchased power prices that exceeds its current rates does not qualify as sufficient reason to lift the cap. Tucson Electric Power's coal-fired generation provided 96% of the energy needed to serve retail load in 2003, and this low-cost resource base provides somewhat of a hedge against rapid cost escalation. However, a significant forced outage of one of its base load units or a run-up in coal prices with any coal contract reopeners represent exposures for the utility. (UniSource Energy Corp., Tucson Electric's parent, recently acquired the gas and electric distribution assets formerly owned by Citizens Communications. In conjunction with this purchase, the ACC approved an FPPA for these smaller operations, UNS Gas and UNS Electric.)

Public Service New Mexico faces circumstances similar to Tucson Electric Power's. It has no FPPA and in January 2003 negotiated a rate settlement that will lower rates 2.5% in 2005 and then hold rates constant until 2008. The utility owns generation that exceeds native loads, the majority of which is coal and nuclear.

FPPA Design and Implications for Credit Quality

While the use of FPPAs has become common, FPPAs are not uniform in design and consequently, their ability to protect utility credit quality varies. For example, some FPPAs are structured to insure cost recovery in a catastrophic market movement by capping a utility's exposure, but at the same time may have a relatively long lag time for a utility seeking to recover more mundane, month-over-month changes in costs. There are a number of features of FPPAs that are important for credit quality.

Triggers.

From a credit perspective, some of the strongest FPPA are found in the generation and transmission cooperative sector, where wholesale rates are often adjusted monthly. Such timely pass-through of fuel and purchased-power costs is rare in the IOU sector. Instead, IOU FPPA typically track costs in a balancing account, the amounts of which are not reflected in the retail rates as a charge or rebate until a predetermined threshold or trigger is hit. Clearly the lower the trigger, the more frequently the utility is able to adjust its rates to reflect cost changes.

Two contrasting examples can be found in California and Washington. In California, true-ups are not tied to an annual process. Assembly Bill 57, passed by the California state legislature in 2002, provides guidance to the California Public Utilities Commission (CPUC) as to how San Diego Gas & Electric Co., Pacific Gas & Electric Co., and Southern California Edison Co. are to recover procurement costs. Specifically, each year the utilities file their forecast fuel and purchased-power revenue requirements for CPUC review. (These forecasts exclude revenues collected for the California Department of Water Resource contracts). Once the forecast is approved, it is used to set rates. Deviations from the forecasts are tracked in a balancing account called the Energy Resource Recovery Account (ERRA). An adjustment to rates is triggered if the ERRA account is over- or undercollected by 5% of the utility's actual recorded generation revenues for the previous calendar year. This trigger, however, expires Jan. 1, 2006, after which there is uncertainty about what kind of mechanism will exist.

FPPAs may also be tied to dollar thresholds. The Washington Utility and Transportation Commission (WUTC) has approved an energy recovery mechanism for Avista Corp. that requires it to absorb the first $9 million of annual energy cost increases above base rates. Beyond this level, costs are deferred for later rebate and a surcharge is implemented when accumulated deferrals exceed 10% of base retail revenues. Alternatively, utilities may simply be subject to an annual reconciliation

process in which actual versus forecast costs are used to adjust base rates. Idaho Power Co. (A-/Watch Neg/A-2) has such an approach.

Sharing mechanisms.

Commonly, FPPAs split the costs (savings) between the ratepayer and shareholder for fuel and purchased power that exceed a forecast range. For example, Puget Sound Energy Inc.'s FPPA requires that it absorb (or may benefit from) the first $20 million of increases (decreases) in actual versus forecast costs relative to baseline rates. For the next $40 million difference, 50% is borne by shareholders in the form of a FPPA adjustment, 10% of the next $80 million, and 5% of any amount more than $120 million, although through a temporary cap, Puget's exposure is limited through mid-2006.

Similarly, though more simply, APS' proposed power supply adjuster seeks a flat 90%/10% ratepayer/shareholder split in costs or savings. The same is true for Idaho Power's power cost adjustment. On balance, FPPAs that provide for fixed or high levels of ratepayer sharing are beneficial to credit quality because they trade upside benefit for downside protection.

Exposure caps.

Utility caps on losses are uncommon, but can be very useful for credit quality as they limit the utility's exposure resulting from extreme market volatility, which could otherwise erode financial health. For example, Public Service Co. of Colorado's (BBB/Stable/--) electric commodity adjustment limits the utility's maximum loss from fuel and purchased power expenses to $11.25 million. For the limited period from July 2002 through July 2006, the WUTC has provided Puget Sound Energy with a cap on its pretax exposure to purchased-power variations of a cumulative $40 million, plus 1% of the overage.

Prudency reviews.

Most FPPAs include caveats that allow the regulator to disallow costs if they are found to be imprudent. How complete this authority is determines how much the FPPA can be relied on, particularly in situations of extreme market volatility or when the utility is forced into the market to purchase replacement power to cover an owned plant outage. APS' proposed power supply adjuster is an example of a mechanism that gives regulators virtually unlimited authority to disallow costs. The ACC may elect to review the prudency of fuel and power purchases "at any time" and any costs flowed through the adjuster "shall be subject to refund if the Commission later determines that the costs were not prudently incurred."

By contrast, language that allows for prudency but provides the utility a high probability of recovery if certain guidelines are followed is preferable. One example is Nevada Power Co., whose recent experience with prudency disallowances of power purchases devastated its credit quality. Specifically, in March 2002, the Public Utilities Commission of Nevada disallowed $434 million of Nevada Power's purchased-power costs incurred during the energy crisis, causing the utility to lose access to bank lines of credit and to the unsecured credit markets. However, in November 2003, the PUCN approved an integrated resource plan (IRP) in which the company will get approval before entering into long-term PPAs. Its short-term power and fuel purchases are adjusted through a new base tariff energy rate, which has features that are similar to an FPPA. While base tariff energy rate costs are still subject to a prudence review, the IRP lays out clear risk-management guidelines, including value-at-risk limits and the use of certain derivative instruments that significantly mitigate the risks of disallowance if the company follows its IRP. Similarly, while California utilities could potentially face a reasonableness review along with its ERRA account, a disallowance is unlikely if the utility follows its procurement plans, which are preapproved by the CPUC.

How Quickly Recovery Is Collected in Retail Rates

Timeliness of recovery is important, as it can have implications for liquidity. California now has one of the strictest rules for timely response. The CPUC must act on a utility's request for an increase (assuming the trigger has been met) within 60 days of a filing. However, the CPUC has discretion in determining over what time period over- or under-collected balances are amortized.

In Arizona, deferrals could theoretically accumulate for long periods if amounts for collection exceed a surcharge cap but fall short of a safety net provision. If approved, APS' proposed PSA would be preset

at a base rate of about 2.1 cents per kilowatt-hour (kWh). While actual costs above or below this level are tracked in a balancing account, true-ups occur only at year's end. At that time, rates are adjusted, but adjustments are constrained by the fact that they may not increase or decrease by more than 4 mills per kWh. However, APS may request the ACC to implement a special surcharge if the account reaches plus or minus $50 million at any time.

FPPA sunsets.

From a credit quality perspective, it is important to note that FPPAs are rarely established as a permanent component of a utility's rate structure. Thus, Standard & Poor's is mindful that FPPAs can be weakened or eliminated altogether once their initially authorized period expires. In the West, many of the FPPAs that have been implemented since 2002 have a sunset provision. For example, Puget Sound Energy, Public Service of Colorado, and California's three largest IOUs have FPPAs that expire Jan 1, 2006. If APS' proposal is approved, it will be in place for five years, at which time the ACC will conduct a review and determine whether it should continue. Another useful example is Portland General Electric Co. (BBB+/Watch Neg/A-2). The Oregon Public Utility Commission authorized a temporary FPPA to recover deferrals incurred in 2001 and 2002. The mechanism was discontinued in 2003. Today, the company has a quasi-FPPA; i.e., rates are updated annually through a resource valuation mechanism process, but if during the year the utility is unable to collect all of its costs through rates, it must make a special filing before the commission to recover the shortfalls. This experience highlights the fact that while many utilities may be currently protected through FPPA, this may not be the case for long.

Are FPPA the Holy Grail of Utility Credit Quality?

Standard & Poor's is frequently asked what weight is given to FPPA. It is clear that continued gas price volatility and upward trends in historically stable coal prices underscore the importance of FPPAs. Some western IOUs have sold their generation and will continue to rely on power purchases to meet retail load growth far into the future. However, it is also clear that FPPAs vary substantially in their ability to protect utilities daily and under catastrophic market movement. Moreover, it is critical to note that FPPAs are not a substitute for supportive regulation; the regulator's ability to disallow costs through ex-post prudency review, regardless of the existence of an FPPA, is a fact of life for utilities. But to the extent that an FPPA is transparent and well structured, regulators are likely to be less inclined to disallow a utility's fuel and purchased-power costs.