

TO: BOARD OF DIRECTORS
FROM: EXECUTIVE COMMITTEE
SUBJECT: CPS ENERGY PROPOSED RATE ADJUSTMENT



STATUS: ADOPTED **DATE: 02/25/2010**

RECOMMENDATION: That the Board of Directors of The Greater San Antonio Chamber of Commerce adopt the following statement as policy:

STATEMENT: The Chamber supports CPS Energy's proposed 7.5 percent electric base and 8.5 percent natural gas base rate increases as mechanisms to maintain the utility's financial stability and strong credit rating. Our community's economic success has been driven in part by our low and reliable energy costs. CPS Energy's aging power plants and energy infrastructure, combined with continued local growth, necessitate the replacement, upgrade and purchase of hundreds of millions of dollars in equipment and materials. The Chamber encourages CPS Energy to continue to seek ways to minimize operational costs and maintain financial accountability. The Chamber supports the original staff recommendation, fairly allocating the cost of the rate increase to all classes of customers. Additionally, The Chamber supports further study of a more progressive rate structure by CPS Energy.

BACKGROUND:

CPS Energy is the largest community-owned gas and electric utility in the nation. With \$9.4 billion in assets, CPS Energy is the fourth largest electricity generator in the Electric Reliability Council of Texas (ERCOT) power region. CPS Energy's diverse mix of generation provides San Antonio's business and residential customers with low-cost and reliable electricity, and has made CPS Energy one of the most competitively priced utilities in the state. Today, coal-fired generation satisfies more than 38 percent of greater San Antonio's electrical energy demand, followed by nuclear energy at 35 percent. Natural gas-fired generation and oil-fired generation make up about 16 percent of the generation fuel mix. Renewable energy, including wind, solar and landfill-generated methane gas comprise the remaining 11 percent of CPS Energy's diverse generation fuel mix.

CPS Energy is seeking City Council approval for electric and gas rate increases and the issuance of bonds to meet proposed capital budget requirements to replace, overhaul or expand major infrastructure. The utility is also seeking rate increases to support a \$500 million operating budget. Nuclear energy expansion is not a part of this rate relief request and is not included as part of the base capital plan.

Energy Generating Infrastructure Budgeted Costs

CPS Energy operates 16 power plants that generate 4,000 megawatts of energy today for the greater San Antonio community. Thirteen of those plants use natural gas to produce electricity while three are powered by low-sulfur coal. CPS Energy's 16 power plants range in age from 5 to 44 years old and the average life of a power plant is about 30 to 40 years. CPS Energy's Sommers, Deely and Spruce power plants are located at the Calaveras Power station. The two Sommers units were completed in 1972 and 1974 and can operate using natural gas or fuel oil with a combined capacity of 880 megawatts. The two Deely units were completed in 1977 and 1978 and use coal to generate 860 megawatts. Spruce 1, completed in 1992, is coal-fired and produces 550 megawatts.

Spruce 2, a new coal unit that is more than 90 percent complete, is scheduled to provide power to the community beginning this summer. Spruce 2 is the largest, most energy efficient power plant in CPS Energy's generation fleet. This \$961 million unit features state of the art air quality equipment and controls. The air emissions reductions equipment includes a Selective Catalytic Reduction System (SCR) which reduces nitrogen oxide (NO_x) emissions, 15,000 giant filter bags that trap fly ash, and an FGD scrubber which traps sulfur dioxide (SO₂). This \$250 million environmental control system makes Spruce 2 one of the cleanest operating coal units in the nation. \$113 million is allocated for the completion of Spruce 2. When completed in summer 2010, Unit 2 of the Spruce Power Plant will provide 750 megawatts of electricity.

The Braunig power station has three units. Built between 1966 and 1970, these 40-year-old units are capable of operating on either natural gas or fuel oil at a combined capacity of 885 megawatts. Adjacent to the Braunig units is the Arthur von Rosenberg plant. It uses both steam and natural gas turbine technology to produce electricity. Completed in 2000, it can generate 481 megawatts.

In addition to its conventional plants, CPS Energy also has two sets of quick-start power generators, or peaking units. One set of peaking units is located at Leon Creek near Port San Antonio on the City's Southwest side. The newest set of peaking units is being constructed at the Braunig power station and will be completed this year. The units run on natural gas and can ramp from a complete shutdown to full load in less than ten minutes. \$6 million is allocated to complete the peaking unit project at Braunig. The addition of more natural gas peaking units will allow CPS Energy to respond to increased demands for electricity during hot summers when energy use is at its highest and when energy prices for this power (if bought from the ERCOT grid) would also be at their highest.

With major changes to air quality standards expected from the federal government in the near future, CPS Energy is adding the SCR at Deely's unit 2 so that the older 405 megawatt unit will meet expected emissions requirements. \$60 million is required to complete the SCR project at Deely 2. The SCR will be operational in the spring of 2011.

The Deely units will also be upgraded with scrubbers to reduce SO₂ emissions. The investment for two scrubbers at the Deely units is \$510 million.

Service Infrastructure Budgeted Costs

CPS Energy's transmission system today has an asset value of \$1.4 billion and includes 6,653 steel poles and towers with more than 1,400 miles of existing transmission circuits. Over the next few years, 125 miles of transmission at a cost of \$142 million will be added through 19 new transmission projects. These projects will support development surrounding Texas A&M University, Port San Antonio and major growth in the western half of CPS Energy's service territory. Additionally, another \$50 million will be spent for 16 transmission upgrade projects in the areas near the Toyota manufacturing plant and the old Sony campus, upgrades necessary to support civic improvements by the City of San Antonio and TxDOT improvements along Wurzbach Parkway.

Substations in particular follow and serve economic development projects. CPS Energy's 103 substations are used to convert higher voltage power from transmission lines to distribution power for delivery to customers at much lower voltage levels. 103 substations are located throughout the CPS Energy's service territory. Eleven new substations are currently planned (\$95 million). Substation projects currently underway include the Holbrook substation, supporting growth at Fort Sam Houston and BAMC as a result of base realignment; Mauermann Road, which supports the development of Texas A&M; 36th Street for Port San Antonio; and Masterson in southwest Bexar County for a high technology and corporate campus park near Highway 90. Eleven more substation projects (\$35 million) will upgrade or expand existing facilities like the old Sony campus. The entire western half of the service territory continues to grow at a rapid pace and upgrades are required to meet the demand. Thirty additional projects are part of the utility's regular maintenance activities to replace existing equipment and to ensure reliability and power quality. An additional \$83 million is budgeted for transformer replacements.

In its distribution system, CPS Energy has more than 400,000 distribution poles used to provide service. The average age of CPS Energy's distribution poles is 27 years. CPS Energy typically replaces about 1,000 poles per year all over its service area, with a full replacement cycle taking 30 years. The industry average is ten years. Each year, 20 new subdivisions pop up all over town, requiring additional poles to be installed in various areas of the CPS Energy service territory while continuing to meet the challenge of replacing the old poles. \$93 million is needed to meet planned subdivision growth over the next five years and an additional \$54 million is needed for commercial and industrial growth.

Underground circuits are typically installed in residential subdivisions and commercial developments. Of the 4,200 miles of underground cable, 400 of these are direct-buried cable miles that require replacement. \$48 million has been allocated to replace 400 miles of old cable.

Budgeted Civic Improvement Costs

Civic improvement needs are estimated at \$14 million with almost 5,000 miles and \$700 million in buried assets. Civic work, including the relocation of gas mains for TxDOT, the City of San Antonio or Bexar County projects has increased by 96 percent in the last two years to approximately \$9 million annually. Additionally, increases in federal and state regulations to ensure gas pipeline safety have added to overhead costs.

Proposed Rate Adjustment

CPS Energy is requesting a rate increase from City Council to support the issuance of bonds to meet \$956 million in proposed capital budget requirements through January 2012 (\$523 million in FY 2011 and \$433 million in FY 2012 - see diagram on page 6). CPS Energy plans to issue \$ 1 billion in bonds over the next 2 years to support the capital program. The first of these bond transactions will be for \$379 million and is scheduled for this spring. Additional bond transactions are planned for the fall of 2010 (\$330 million) and the fall of 2011 (\$285 million). The proposed rate adjustment will provide the support to pay the debt service on these bond transactions. Furthermore, CPS Energy anticipates additional rate increases every other year through 2021. This series of rate increases is part of CPS Energy's long range financial plan to meet the community's energy needs while maintaining its strong credit rating for continued access to the capital markets.

CPS Energy proposed an electricity base rate increase of 7.5 percent for residential customers and an electric base rate commercial increase ranging from 7 percent increase for small commercial customers to 8.8 percent for large industrial customers. The utility is also proposing an 8.5 percent increase in natural gas rates for both residential and commercial customers. CPS Energy staff estimates a required \$99 million dollars in additional revenue in 2011 and \$110 million dollars in additional revenue in 2012 to primarily fund operational expenses, debt service, maintenance and the capital program.

However, the base rate increase will not raise customers' total bills by that amount. A substantial part of each bill consists of an automatic adjustment for fuel and purchased power expenses. Because natural gas fuel costs will go down when Spruce 2 begins producing power with lower-cost coal (Summer 2010), CPS Energy estimates that residential electric customers' total bills, after the base rate increase, will average 3.4 percent for electric service and 4.2 percent for gas service.

Additional Recommendations

While we recognize and support the need for this rate adjustment, we additionally recommend opening a future dialogue regarding whether the current rate structure can be more transparent and not only provide better price signals for making good decisions but to also promote energy conservation and efficiency. Specifically, over time, the "fuel adjustment clause" has included more and more costs that could arguably be in the base rate. For example, we understand that most, if not all, of the cost of purchased renewable power is currently recovered in the fuel adjustment

charge; yet those contracts are long-term power purchase agreements with fixed minimum purchase obligations. To the extent that CPS Energy has long-term fixed-price coal and transportation contracts, those costs could also be part of the fixed base rate.

The STEP program costs, many of which involve capital commitments to encourage efficiency and demand reduction, also arguably belong in the base rate, not the fuel adjustment. We believe homeowners and businesses are better able to budget for and afford their energy bill if the fuel adjustment is limited to truly short-term, unpredictable costs, such as increases needed to the fuel cost to cover escalations in the price of natural gas or increased costs associated with power purchases from the ERCOT market (net of market power sales) to cover generation needs not met through the CPS Energy generation portfolio.

Key Reasons for Support of CPS Energy's Proposed Rate Structure

- Pros-
1. The proposed rate structure will assist in maintaining CPS Energy's strong credit rating, reliability and predictability which are all critical to the City of San Antonio's strong financial stability.
 2. If the full rate increase amount is not approved, key projects needed to maintain reliability including operations and maintenance needed on existing CPS Energy assets will not be able to be performed, jeopardizing the quality of service that both the business and residential customers of CPS Energy have come to expect.
 3. The rate proposal by CPS Energy will not serve to divide the community as some of the alternative, more progressive options would, while still encouraging larger users to respond to price signals through energy efficiency or using the CPS Energy weatherization programs.
 4. Since the City of San Antonio receives 14 percent of CPS Energy revenue, this rate increase continues to be critical piece of the City budget.
 5. Even with the proposed rate increase, San Antonio residents and businesses will continue to benefit from some of the lowest energy costs in the state. CPS Energy is committed to maintaining rates 10 percent below their competitive market (which includes Corpus Christi, Dallas and Houston).

Financial Issues Remaining if CPS Rate Proposal Approved

- Cons-
1. Even with the rate increase proposed by CPS Energy, the financial projections show that CPS Energy may still be behind given that their last requested rate increase after a 17-year period without any rate increases was not fully funded, while competitive markets saw double digit rate increases. A significant portion of CPS Energy's capital program in recent years was funded by increasing debt and this trend is projected to continue going

forward. This is at the cost of increasing CPS Energy's debt load and weakening of its financial flexibility in accessing capital markets.

2. To the extent rate increases fall disproportionately on business, as jobs are lost, the ability of residential customers to continue to pay will be lost.

IMPLEMENTATION: The Chamber will communicate this position to the CPS Energy Board of Trustees and to the Mayor and members of the City Council, the media and The Chamber membership through public testimony, letters, publication in *The Chamber Today* and media releases.