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ARIZONA CORPORATION COMMISSION

KRISTIN K. MAYES
Commissioner

Direct Line: (602) 542-4143
Fax: (602) 542-0765
E-mail: kmayes@azcc.gov

June 28, 2006

Mr. Jack Davis
President and CEO
Arizona Public Service Company
400 East Van Buren
Phoenix, AZ 85004

Re: Calculation of Above Market Cost for Wind Energy; APS General Rate Case, Docket No. E-01345A-05-0816; Renewable Energy Standard & Tariff Rules, RE-00000C-05-0030

Dear Mr. Davis:

As part of Decision No. 67744, the Commission required Arizona Public Service ("APS") to acquire 100 MW of renewable energy resources. As part of this decision, the Commission ordered that the cost of the renewable resources could not exceed 125 percent of the cost of conventional resource alternatives. After conducting a Request For Proposal, APS rejected several in-state projects in favor of out-of-state wind after determining the in-state projects exceeded the 125 percent threshold. Decision No. 68296 authorized APS to contract with Superior Wind in New Mexico for energy generated by the Aragonne Wind project. This decision also required APS to work with Staff to reevaluate the Arizona wind projects that were rejected by APS. Ultimately, in Decision No. 68486, the Commission reconsidered both wind projects but found, pursuant to APS' calculations, that both were above the 125 percent threshold. They were therefore rejected.

During the deliberations on these matters, the Commissioners were unable to discuss the assumptions underlying APS' calculation of Avoided Total Cost as these assumptions were deemed to be confidential and proprietary. As the Commission continues to move forward with the Renewable Energy Standard ("RES") and further expansion of renewable energy in pending cases with APS and Tucson Electric Power ("TEP"), I believe that it is important to gain a better understanding of what costs, charges and penalties go into the calculation of avoided total cost, or above market cost.

Specifically, I would like the Company to provide comment in these dockets on the calculation of above market cost for renewable energy, with a particular focus on in-state wind energy. I am cognizant that the calculation of these costs is considered to be confidential and proprietary, so information specific to any case that the Company believes is proprietary could be provided to the Commission under confidential seal.

First, I would like APS to provide the Commission information on the Company's calculation of ancillary service costs. While these costs are "hard" costs that a utility incurs to connect wind energy to the grid, I am interested in ascertaining the $/mWh cost that APS is currently calculating for in-state wind projects. The Colorado Public Utility Commission's Xcel Wind Decision in 2001 found that ancillary services for new wind are not a major cost.[1] In this case, Xcel Energy forecasted that the ancillary services attributable to the proposed 162 MW Lamar wind facility would cost $41-48 million. Colorado PUC Staff estimated that these costs would be in the range of $3-6 million. The Colorado PUC did not adopt a particular method for calculating ancillary services but ultimately determined that the actual level of ancillary costs for this project was in the lower range advocated by PUC Staff, which made the Lamar project cost effective. In order to appropriately price in-state wind projects, I believe that it is necessary for this Commission to understand the ancillary service costs that APS is utilizing for their calculations.

Second, I am concerned about the calculation of imbalance penalties in determining above market costs. Whereas ancillary service costs are "hard" costs incurred by a utility, imbalance penalties are arbitrary by nature. Imbalance charges were developed as part of the pro forma Open Access Transmission Tariff (OATT) to ensure that generators' actual output matched their scheduled output. As wind is an intermittent resource, penalties levied on actual output versus scheduled output defeat the very purpose of pursuing renewable energy and are inherently punitive. In April, 2005, FERC issued new rules to increase participation of wind energy in the marketplace. This Notice of Proposed Rulemaking (NOPR) established a new generator imbalance service schedule under the pro forma OATT for intermittent resources that essentially removed the existing barriers of entry to the market for wind resources. I would like APS to provide the Commission specific information on how they calculate imbalance penalties for wind energy. At the Renewable Energy Standard and Tariff (REST) Public Comment meeting on June 5, 2006, I engaged in a dialogue with Pat Dinkle from APS on this topic.

> COM. MAYES: It was my understanding that Arizona utilities were among the few left in the country that do still charge the imbalance OATT. Are you saying your imbalance charge is different from the imbalance OATT?
> MR. DINKLE: Yes.
> COM. MAYES: As you're aware -- okay. So you're not charging the imbalance OATT?
> MR. DINKLE: We're not charging the imbalance OATT. What we're doing is calculating the cost to integrate the resource just as we would any other generation resource in our system. We're treating it as what is called a network resource so that if we were to buy that wind resource, we would integrate it into our system as we would other generation resources.[2]

I would like additional information on APS' calculation of imbalance charges and how this relates to FERC's NOPR on new tariffs for wind energy as well as how these

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[1] Colorado PUC Decision No. C01-295
[2] See Transcript Pages 247-248.

calculations work into the total calculation of above market cost for wind projects. Mr. Dinkle's testimony suggests that while APS is not charging an OATT imbalance penalty, the Company is imposing a de facto imbalance fee against wind projects, potentially pushing them out of the cost-effective range. Please describe APS' imbalance penalty policy and describe how it would be applied to a hypothetical wind project.

Finally, please tell the Commission whether the Company charged an ancillary service fee and/or an imbalance penalty against the projects that were subject of Decision No. 68486.

This information will aid the Commission as we move forward with additional renewable energy projects, specifically wind projects, as both part of the REST and as we seek additional energy resources to meet Arizona's growing demand for energy.

Sincerely,

Kris Mayes
Commissioner

Cc: Chairman Jeff Hatch-Miller
Commissioner William A. Mundell
Commissioner Marc Spitzer
Commissioner Mike Gleason
Brian McNeil
Ernest Johnson
Heather Murphy