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May 13, 2004

Arizona Corporation Commission
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DOCKETED BY

Ray Williamson
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona

Re: ***Docket No. RE-00000C-00-0377, Arizona Public Service Company Proposal for Alternative EPS Program***

Dear Mr. Williamson,

Attached to this letter is an alternative Environmental Portfolio Standard ("EPS") proposal prepared by Arizona Public Service Company ("APS"). This proposal is intended to move APS towards a broader and more flexible EPS program, and respond to policy recommendations discussed by the Commission and in the EPS Working Group.

The core components of APS' proposed alternative EPS program are a higher EPS goal of between 3.5% and 5% of APS' retail energy by 2015, coupled with an open Request for Proposals ("RFP") process to solicit bids for renewable resources and renewable energy projects from the industry.

In addition, APS is proposing two alternatives for its modified EPS program to respond to policy recommendations that have been discussed by either parties in the EPS Working Group, the Staff or the Commission. One alternative would focus on achieving the higher 5% EPS goal by removing restrictions on the mix of technologies to achieve that goal. The second alternative would target a somewhat lower 3.5% goal, but would set aside specific funding for distributed solar resources. Under either alternative, APS has designed the funding components of the program to continue to support significant development of in-state solar resources

The proposed EPS program was developed assuming an initial annual funding requirement of $20 million. An adjustment mechanism would be used to collect the portion of this funding requirement that is not included in APS' base rates. The adjustment mechanism would also allow changes in the funding level to reflect either increased or decreased cost requirements as the program is implemented.

The specific rates in the adjustment mechanism can be designed to collect program funding either with or without caps on customer classes.

I look forward to discussing this proposed alternative EPS program with you and the parties to the EPS Working Group. Please do not hesitate to call me if you have any questions or comments.

Sincerely,

Edward Z. Fox

cc: Chairman Marc Spitzer
Commissioner William A. Mundell
Commissioner Jeff Hatch-Miller
Commissioner Mike Gleason
Commissioner Kristin K. Mayes
Ernest Johnson, Director, Utilities Division
Christopher C. Kempley, Chief Counsel
Barbara Keene
Docket Control

Arizona Public Service Company
Proposed Environmental Portfolio Standard Program

May 13, 2004

In place of the existing Environmental Portfolio Standard ("EPS") set forth in A.A.C. Rule R14-2-1618 ("Rule 1618"), APS proposes that the Arizona Corporation Commission ("ACC") modify the EPS as described below or grant the Company a variance to implement this proposal as an alternative EPS program. This alternative EPS program is designed to use an open RFP process as the principal mechanism to acquire new renewable resources and to increase the EPS goal to between 3.5% and 5% of APS' retail energy by 2015.

I. EPS Program Targets.

APS' objective is to develop an EPS program that has a meaningful chance of achieving a 5% EPS goal by 2015, using all available renewable technologies and an initial funding level of $20 million annually through 2015. Although APS proposes removing the 60/40 solar/other resources mix, the Company believes that the 5% goal can be achieved with a balance of technologies.[1] APS also recognizes that there may be a desire to provide for set-asides for distributed solar technologies, even though such an approach would reduce the EPS goal that could be achieved by 2015. Thus, APS proposes two alternative EPS goals and a review process to ensure that progress towards the alternative selected is being made:

- **Alternative 1.** An EPS goal of 5% of retail energy by 2015 without restrictions on technology mix in achieving that goal.
- **Alternative 2 - Distributed Solar Option.** An EPS goal of 3.5% of retail energy by 2015 with a set-aside of $5 million per year in EPS program funding for distributed solar technologies (generally up to 100 kW), including solar hot water heating. If the distributed program is under-subscribed in a given year, remaining funds would available to APS for other EPS programs.
- **Review Process.** In 2007, after experience with actual RFP results, and as part of the EPS reporting process with the Utilities Division Staff, APS shall submit a status report and a recommendation to the Commission as to whether the then-current funding level should be modified to meet the EPS goal and the status of achieving the EPS goal within the time-frame established. The status report will also address any changes in state or federal subsidies for renewable resources.

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[1] APS' proposal assumes that the "extra-credit" multipliers in Rule 1618 would expire on the current schedule with the exception of the installed solar multiplier. Under APS' proposal, that 2.0 multiplier would continue to provide an incentive for the construction of additional solar resources through 2015.

II. EPS Resource Procurement

For the majority of its proposed EPS program, APS would use a fair and flexible request for proposals (RFP) process for in-state[2] resources to allow the renewable energy market to respond to the EPS program goals. In addition to the RFP process, existing commitments would continue to be satisfied. APS could also reserve funding, after consultation with Staff, to implement "signature" public works-type projects outside an RFP that may be funded with up-front capital. In general, the resource procurement elements of APS' proposed program are:

- Current EPS contracts and public commitments of APS would continue to be funded from EPS revenues. Once contracts and commitments expire, available funding would be added to the RFP process. At present, these current commitments include but are not limited to the Eager Biomass Project, the Prescott solar facility, the Saguaro solar trough project, the Cochise Community College solar water heating project, the City of Mesa 91st Avenue biogas project, and APS' current wind PPA with Western Wind near St. Johns, Arizona.
- RFPs for least-cost, in-state renewable resources—including Purchase Power Agreements, renewable credits or tags, asset purchases, and/or new construction—would be issued by APS on a periodic basis, with broad public and industry notice and opportunities for potential bidders to participate in the implementation of the RFP process.
- The types of renewable resources that could participate in the RFP and count towards the EPS would be broadly defined to include geothermal and small hydro resources in addition to the types of resources already defined in Rule 1618 and any other types of resources approved by the Commission.
- APS will submit to the Commission for approval any proposed long-term (over 5 years) Purchase Power Agreements for renewable resources. Staff will be notified of all RFPs and the results as part of the required reporting for the EPS.
- For Purchase Power Agreements, to the extent that APS has a power supply adjustment mechanism in place, EPS funds will be applied only to the "premium" above an indicative market price determined by APS at the time of the RFP. The market component of the Purchase Power Agreement will be recovered through the power supply adjustment mechanism.[3]

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[2] The intent of the RFPs would be to solicit for in-state resources. APS would be permitted to solicit for out of state resources, after reviewing the results with Staff, if the RFPs yield insufficient bids for low-cost in-state renewable resources to meet the proposed EPS goals.

[3] For example, assume that APS has a power supply adjustment mechanism in place and enters into a PPA for wind resources at 5 cents per kWh. At the time the PPA is accepted, APS would determine the market price for a non-renewable resource contract of the same size and with the same general characteristics (dispatchability, delivery point, etc.) as the wind contract. If the market price for such a contract is 3 cents per kWh, 2 cent per kWh of the wind PPA would be funded through the EPS and 3 cents per kWh would be treated as a market purchase subject to the power supply adjustment mechanism.

- If funding remains uncommitted from an RFP process in any given year, APS may either retain the uncommitted funding for a subsequent RFP or apply such funding to constructing utility installed or supported renewable energy projects.
- For accepted bids that do not require funding to commence at the time of the RFP, the funding available during any lead-times before commercial operation of the project may be used for utility installed or supported renewable energy projects.[4]

III. EPS Program Funding.

Current EPS funding does not collect sufficient revenues to permit APS to meet the EPS goals. The current EPS surcharge mechanism also does not provide sufficient flexibility to adjust funding based on changes in the cost of compliance, timing, or resource mix of the EPS. To address these issues, APS proposes that a more flexible and responsive funding mechanism be adopted for the Company:

- An adjustment mechanism based on energy consumption (mills/kWh) would be established in APS' pending rate case to collect the amount of revenue not included in the Company's base rates that is necessary for APS to comply with the EPS program.
- The adjustment mechanism would be allowed to either increase or decrease the funding outside of a rate case based on changes to the required funding levels.
- Initial funding for APS' EPS program (including both amounts already in base rates and amounts recovered through the adjustment mechanism) would be set at $20 million per year.
- The Commission should review or establish customer class caps when it authorizes the adjustment mechanism or when subsequent changes to the level of funding collected by the adjustment mechanism are made by the Commission.

[4] For example, if APS selected a $5 million per year renewable Purchase Power Agreement in an RFP for 2005 program expenditures, but the contract for the Purchase Power Agreement would not commence until 2008 to allow construction of a project, the $5 million would be applied to utility installations of renewable energy projects in each year from 2005 through 2007.