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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

2005 MAR 18 P 3:53

JEFF HATCH-MILLER, Chairman

WILLIAM A. MUNDELL

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AZ CORP COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR A
HEARING TO DETERMINE THE FAIR VALUE
OF THE UTILITY PROPERTY OF THE
COMPANY FOR RATEMAKING PURPOSES, TO
FIX A JUST AND REASONABLE RATE OF
RETURN TEHREON, TO APROVE RATE
SCHEDULES DESIGNED TO DEVELOP SUCH
RETURN, AND FOR APPROVAL OF
PURCHASED POWER CONTRACT.

Docket No. E-01345A-03-0437

NOTICE OF FILING

Commission Staff hereby provides Notice of Filing a Memorandum that responds to the questions raised in Commissioner Gleason's March 7, 2005 letter. This Memorandum is jointly submitted by the Parties to the Proposed Settlement.

RESPECTFULLY SUBMITTED this 18th day of March, 2005.

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Arizona Corporation Commission

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MEMORANDUM

In a letter to the Parties dated March 7, 2005, Commissioner Gleason requested a definition of the phrase "reasonably estimated market price of conventional resource alternatives" as provided in Paragraph 69(g):

Renewable resources must be no more costly, on a levelized cost per MWh basis, than 125% of the reasonably estimated market price of conventional resource alternatives.

He asked the Parties to address the following issues: 1) the conventional resources to be considered, 2) the basis by which the market price of those resources will be estimated, and 3) the party or parties who will be responsible for making the estimate.

This memorandum has been circulated among the signatories to the Proposed Settlement Agreement, and it represents the Parties' joint responses to the questions that Commissioner Gleason identified.

1) What types of conventional resources should be considered?

When evaluating whether to enter a purchased power or other agreement for renewable resources, APS should analyze the avoided energy and capacity costs associated with the types of conventional generation resources that might ordinarily be used to meet its demand in the future. These conventional resources include natural gas fired combustion turbines, natural gas fired combined cycle plants, coal fired steam plants, and possibly integrated gasification combined cycle plants depending upon existing and projected circumstances at the time of bid evaluation. These various types of conventional resources may be either obtained by APS through wholesale contracts or owned by APS.

2) How will the market price of these conventional resources be estimated?

The estimated market price of these conventional resources should be defined as APS' avoided cost of procuring or generating power. To estimate the avoided cost of procuring or generating power, APS should separately analyze the avoided energy and capacity costs associated with the life-cycle costs of these resources.

Energy value is the avoided cost of fuel and fuel-related costs (and/or energy purchases from the wholesale market). To estimate avoided energy costs, APS should use its production cost or similar modeling capability to identify the mix of conventional generation resources (including market purchases) that would be displaced by specific renewable energy resources with specific operating characteristics, taking into account APS' hourly, seasonal, and long-term supply and demand circumstances. The energy cost of those displaced resources depends on the operating characteristics of the units (heat rate, ramp rate, operation and maintenance costs, forced outage rates, and scheduled maintenance) and/or the contract terms of market purchases. The energy cost also

depends on the forecast price of fuel for the displaced units. APS will consider the following factors when forecasting fuel prices:

- Fuel and power costs specified in existing contracts;
- Forward prices for electricity, natural gas and, if appropriate, coal;
- Forecasts of electric prices, gas prices, and, if appropriate, coal prices, considering factors affecting future prices, such as growth in the demand for natural gas and the uncertainty in such forecasts. APS will review multiple forecasts, such as those provided by commercial vendors and by the Energy Information Administration.

To estimate avoided capacity costs, APS will forecast future capacity values based upon current market prices and on estimates of the costs of building new peak, intermediate, and baseload fossil-fueled capacity. To determine the capacity value of a particular proposed renewable resource, APS will incorporate the expected availability of that resource in its production cost or similar models to determine how much conventional capacity could be displaced by the renewable resource at various times of the year.

Capacity value is a supply and demand function that captures the variability of customer demand and the ability of a generating resource to respond to that customer demand in a reliable and timely manner. Therefore, the avoided cost of capacity must reflect the fact that the value of capacity varies hourly, with typical seasonal swings. Individual renewable generating projects will have different patterns of energy output and different levels of predictability. As a result, the avoided cost associated with any renewable energy project will be project-specific.

3. Who will be responsible for making the estimate?

APS will be responsible for supporting the calculation and applying the method during its review of renewable resource proposal applications. The method will be reviewed with potential bidders during the renewable RFP pre-bid conference specified in the Settlement Agreement, and post-evaluation results will be available for the Commission's review on a confidential basis.

1 Original and 13 copies of the foregoing
filed this 18th day of March, 2005, with:

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