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A subsidiary of Pinnacle West Capital Corporation

Steven M. Wheeler
Executive Vice President
Customer Service & Regulation

October 24, 2005

The Honorable Chairman Jeff Hatch-Miller
The Honorable Commissioner William Mundell
The Honorable Commissioner Marc Spitzer
The Honorable Commissioner Mike Gleason
The Honorable Commissioner Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

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RE: Recent Shutdown of Palo Verde Nuclear Generating Station;
Docket Nos. E-01345A-03-0437 and E-01345A-05-0526

Dear Commissioners:

In response to the letters from Commissioner Mundell and Commissioner Mayes dated October 18, 2005, I would like to make our position clear concerning the recovery of replacement fuel and purchased power costs incurred since April 1, 2005 to serve our customers during unplanned Palo Verde outages.

Although our current PSA surcharge request now includes no costs attributable to unplanned Palo Verde outages (and is indeed significantly less than even the non-Palo Verde related costs), APS intends to seek future recovery of these and other prudently incurred fuel and purchased power costs through the PSA mechanism. Such recovery is, of course, subject to the 90/10 sharing mechanism and the ultimate review of this Commission. Under the 90/10 sharing provision, APS absorbs not only 10% of the Palo Verde replacement costs in excess of the base fuel cost (\$.020743 per kWh) but 10% of all fuel and purchased power costs in excess of base fuel cost, irrespective of the fact that they were prudently incurred to provide service to customers.

From April 1 through October 2005, the additional costs deferred into the PSA bank balance for unplanned Palo Verde outages (after application of the 90/10 sharing) are estimated to be approximately \$40 million. This

figure is calculated by taking gross replacement power costs less the cost of additional nuclear fuel that would have been consumed had the outages not occurred and less the level of unplanned outage costs included in the calculation of base fuel cost previously approved by this Commission. The additional costs attributable to the most recent Palo Verde outage, as discussed in the two Commissioner letters to which I previously alluded, have not been finally determined, but are estimated to be approximately \$14 million after application of the 90/10 sharing and using the same formula as outlined above. In comparison, the total of PSA deferrals through October is presently estimated to be some \$150 million. Thus, even excluding all Palo Verde unplanned costs in excess of the base fuel cost would leave an unrecovered PSA bank balance of \$110 million. And this bank balance does not include the \$17 million in presumptively prudent costs absorbed by APS as a result of the previously mentioned 90/10 sharing provision of the PSA.

APS indicated in its response to Commissioner Mayes' letter of August 4, 2005, that every generating plant ever built has had unplanned outages. It is the expectation of such outages that necessitates the maintenance of adequate reserves by all utilities. Moreover, of the electric utility fuel and purchased power clauses, including the Company's, that of the co-operatives regulated by this Commission, and those in use in some 40 jurisdictions in this country, I am unaware of any that, as a matter of policy, disallow the recovery of prudently incurred replacement power costs attributable to unplanned generating plant outages, irrespective of the number or duration of such outages. In a previous order, the Commission itself labeled a suggestion that replacement power costs attributable to extended unplanned outages should be automatically excluded from recovery through an adjustment clause as "an unreasonable and draconic [sic] position." See Decision No. 55118 (July 24, 1986) at 13. And I must note that there has been no evidence presented that any of these outages were the result of imprudent management.

The Commission went on to conclude that even if one were to equate prudence with the achievement of a specified level of operating results (in that instance, historical capacity factors) irrespective of the circumstances affecting such results, there must be given equal consideration to above-average operating results. "Likewise, a realistic analysis of operating performance must look at both the 'successes' and the 'failures' if it is to avoid setting unobtainable goals of absolute perfection." Decision No. 55118 at 20. Thus, it is APS generation and fuel procurement performance

as a whole that ought to be considered rather than focusing solely on one plant. For example, APS coal plant performance (using the same formula) has reduced the level of deferrals through September by \$11.4 million. Also, APS hedging activities have saved approximately \$49 million (post sharing) over the same period.

The PSA mechanism approved by the Commission permits an examination of the prudence of the Company's fuel and purchased power costs at any time. This has traditionally been done in general rate proceedings on an after-the-fact basis, but the Company also files monthly reports with the Commission detailing, among other things, power plant performance along with a description of all planned and unplanned unit outages. These reports permit the Commission to monitor Company performance on a regular basis and to correspondingly identify areas of possible concern well before the costs deferred during that reporting period will be recoverable under the PSA. This continuous review of Company fuel and purchased power costs, along with the opportunities for prudence examinations in rate or other proceedings, give the Commission ample tools to address the issue of prudence without the need to alter or interrupt the normal operation of the PSA.

Thank you for this opportunity to respond.

Sincerely,



Steven M. Wheeler

SMW:DN

cc: Brian McNeil
Ernest Johnson
Lyn Farmer
Chris Kempley