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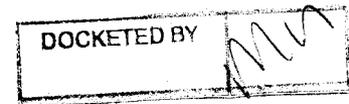
June 4, 2010

Arizona Corporation Commission

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JUN - 4 2010

Kristin K. Mayes, Chairman  
Arizona Corporation Commission  
1200 West Washington  
Phoenix, Arizona 85007



**Re: Funding Shortfalls in Arizona Public Service Company's Renewable Energy Incentive Program - Docket No. E-01345A-09-0338**

Dear Chairman Mayes:

In your May 27, 2010 letter to Don Robinson, you requested that the Company examine its Renewable Energy Standard ("RES") budget projections to look for opportunities to support continued consumer demand for distributed energy ("DE") incentives above the Company's 2010 budget (which had been designed to achieve its residential compliance targets).

APS has done such a review, and as described in detail below, APS will reallocate approximately \$5.3 million of current RES funding towards customer demand for residential and commercial DE incentives in Funding Cycle 2. Of these funds, approximately \$3.5 million will be applied to residential incentives, with the remaining \$1.8 million available to non-residential programs. These additional funds are available as the result of expiring, unexecuted reservations; projects whose in-service dates are different than originally reported to APS; and funds from similarly delayed or expired projects from the Company's 2009 RES budget.

Similarly, the Company believes that additional funds will be available to augment Funding Cycle 3 through the 2010 budget. While it is not possible to reliably predict those funds at this point in the year, APS believes they will be of comparable magnitude to those funds made available to augment Funding Cycle 2. Additionally, APS will be making a future filing for Arizona Corporation Commission ("Commission") clarification as to the maximum amount of 2011 incentive funding the Company should commit to residential customers as part of 2010 Funding Cycle 3.

**Background:** In March 2010, APS filed an application seeking Commission approval to modify its residential DE incentives because unprecedented customer participation in the RES incentive

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program beginning in the fourth quarter of 2009 had nearly depleted the 2010 budget. In Decision No. 71686,<sup>1</sup> the Commission lowered the incentive from \$3.00 per watt to \$2.15 per watt for photovoltaic systems, and from \$0.75 cents to \$0.50 cents per first year kilowatt-hour savings for solar water heaters. The Commission also approved an automatic capacity-based "step down" in the residential incentive for photovoltaic systems. Once the incentive program supports an additional three megawatts of capacity from these systems, the incentive will automatically decrease to \$1.95 per watt. Additionally, the Commission ordered APS to use three funding cycles to pace distribution of the remaining incentive funding throughout the remainder of 2010. Funding Cycle 1 ends on July 1, Funding Cycle 2 ends on October 1, and Funding Cycle 3 ends on December 31, 2010. Of the remaining funding, \$900,000 was specifically allocated for solar water heaters and is to be equally divided among Funding Cycles.

**Current Incentive Funding Status:** At the time the Company sought modification to the incentive program, \$11.4 million was available for residential incentives. However, despite the lower incentive levels for residential photovoltaic and solar water heating systems that resulted from Decision No. 71686, customer demand has not slowed. Funds allocated to Funding Cycle 1 are fully committed to customers installing photovoltaic systems, solar water heating and other distributed energy technologies. Current applications for photovoltaic and other distributed energy incentives will also fully exhaust funds allocated to Funding Cycle 2, once the Company begins to issue reservations for those funds on July 2, 2010. The majority of Funding Cycle 2 funds for solar water heating remain available at this time. Currently, approximately \$7.1 million in photovoltaic incentive applications have been received for approval in Funding Cycle 3.

**Funds Available to Augment Incentives in Funding Cycle 2:** Based on the Company's normal business practices in implementation of its DE incentive programs, APS has examined RES budget projections, as well as current commitments for both residential and non-residential distributed incentive programs. APS believes that the following sources for incentive funds will be available for addition to Funding Cycle 2. Similarly, APS believes that additional funding from some of these same sources through the third quarter of 2010 will be available to augment Funding Cycle 3 with the 2010 budget.

**2009 Incentive Cancellations:** In the current Funding Cycle, consistent with the Company's normal business practice, all cancelled up-front incentive ("UFI") funding commitments ("reservations") will be added back to the incentive funds available to customers for their respective residential or non-residential UFI program. Generally, cancellations occur either as a function of the inability of customers to meet program requirements (e.g., program timelines) or as a result of a customer's request. Based on historical cancellation rates, APS anticipates that

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<sup>1</sup> Issued April 30, 2010.

approximately \$800,000 could become available for Funding Cycle 2.<sup>2</sup> The actual amount will be entirely dependent upon customer cancellation rates.

***Production-Based Incentive Projects:*** APS is forecasting unspent funds from budgetary commitments to non-residential projects receiving production-based incentives ("PBI"). Customer projects occasionally do not come into service as forecasted in the original application, although they continue to meet all required program milestones. These delays in operation may result in unspent PBI budget dollars in the current calendar year. Based on currently projected in-service dates for PBI projects through June 30, 2010, APS anticipates that approximately \$2.6 million in PBI funds will not be needed to meet contract commitments through the second quarter of 2010. APS will reaffirm these unused funds as of June 30, 2010 and will apply half of any unused PBI funds towards residential incentives, making the overall reallocation equal to both the residential and non-residential programs.<sup>3</sup> APS will repeat the same procedure at the close of the third quarter and reallocate funds for Funding Cycle 3.

APS believes some projects with current PBI reservations will fail to sufficiently advance and/or come into service within the pre-specified program timelines. These timelines, and the specific requirements of each, are described in the Company's Distributed Energy Administration Plan. Based on the increased demand for incentive funding for PBI projects, the associated annual budget for production payments, and the "lifetime authorization" committed to each project, the Company believes it is increasingly important to require projects to firmly adhere to prescribed timelines. The Company has observed that a significant number of PBI projects are likely to be cancelled or have the reservation expire over the third quarter of 2010. PBI payments that are freed-up as a result of these cancellations/expiration will likewise be applied towards residential and non-residential UFIs in the appropriate Funding Cycles.

***2009 DE Request for Proposals Reallocations:*** APS signed contracts with three developers for non-residential DE projects that resulted from the Company's 2009 DE Request for Proposals ("DE RFP"). The Company's 2010 Implementation Plan anticipated that some of those projects would come into service in the first half of 2010; however, it is currently projected that those projects will not be operational until late-2010 or 2011. As a result, APS anticipates that approximately \$1.2 million that had been budgeted for DE RFP projects in 2010 will not be needed to meet contract commitments this year. This funding will be

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<sup>2</sup> The 2009 budget for the UFI program reflects an approximately 75/25 split between residential and non-residential incentives. This same proportionality will be reflected in the reallocation of these funds.

<sup>3</sup> Pursuant to Decision No. 70313, APS has the flexibility to reallocate up to 20 percent of incentive funds into the DE budget in order to match customer demand.

reallocated equally to Funding Cycles 2 and 3, resulting in \$600,000 of available funds for Funding Cycle 2. APS will reallocate these funds equally between the residential and non-residential UFI programs in both Funding Cycles 2 and 3.

**Uncommitted Funding from 2009:** In addition, at the close of 2009, there was approximately \$1.3 million of uncommitted non-incentive funding that was budgeted for implementation costs. These cost savings during 2009 were from two sources: 1) slower-than-expected growth in demand for residential DE systems in the first half of the year; and 2) delays in the implementation of some aspects of the non-residential DE program, which resulted from constraints in lifetime authorization for PBI commitments. APS believes that it would be appropriate to apply these funds to residential incentives.

The following table summarizes the total proposed funding reallocations for Funding Cycle 2 in 2010, including the breakout of funds to both residential and non-residential incentive programs.

<b>UFI Budget Reallocations for 2010 Funding Cycle 2<sup>4</sup></b>			
<b>In \$ million</b>			
<b>Category</b>	<b>Residential</b>	<b>Non-Res</b>	<b>Total</b>
<b>2009 Incentive Cancellations</b>	\$ .6	\$ .2	\$ .8
<b>2010 PBI Reallocations</b>	\$1.3	\$1.3	\$2.6
<b>2009 DE RFP Reallocations</b>	\$ .3	\$ .3	\$ .6
<b>2009 Uncommitted Funding</b>	\$1.3	-	\$1.3
<b>2010 UFI Budget Reallocation</b>	<b>\$3.5</b>	<b>\$1.8</b>	<b>\$5.3 million</b>

In summary, at this time, APS anticipates that approximately \$5.3 million may be available to meet increased demand for DE incentives above those currently forecasted for Funding Cycle 2. APS believes that the reallocation of funds discussed above can be accomplished through the course of normal program implementation practice, and APS plans to make these reallocations as funding becomes available. To provide transparency and notice to customers and interested parties, as required by Decision No. 71686, the amount of residential incentive funding remaining for the current reservation period and weekly cancellations will be updated on a weekly basis on APS's website. In addition, in the near future APS will be filing for Commission clarification as to the amount of 2011 residential incentive funding that should be committed during Funding Cycle 3.

APS is encouraged with the level of customer participation in the DE program, and appreciates the Commission's interest in maintaining optimal financial support for the 2010 Funding Cycles.

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<sup>4</sup> All numbers are estimates only, actual amounts will be calculated at the close of Funding Cycles or quarterly reporting.

Kristin K. Mayes, Chairman  
June 4, 2010  
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As always, representatives of APS are available to discuss these issues in more detail, at your request.

Sincerely,

A handwritten signature in black ink, appearing to read "Deborah R. Scott". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Deborah R. Scott

DRS/rlj

cc: Don Robinson  
Commissioner Gary Pierce  
Commissioner Paul Newman  
Commissioner Sandra D. Kennedy  
Commissioner Bob Stump  
Ernest Johnson  
Steve Olea  
Janice Alward  
Rebecca Wilder  
Parties of Record

Copies of the foregoing hand-delivered/emailed  
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