

ORIGINAL



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MEMORANDUM

36

TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: September 30, 2005

RE: STAFF REPORT FOR ARIZONA PUBLIC SERVICE COMPANY NOTICE OF
INTENT TO INCREASE EQUITY DOCKET NO. E-01345A-05-0520

Attached is the Staff Report for Arizona Public Service Company's notice of intent to increase equity. Staff recommends approval.

EGJ:DTZ:red

Originator: Daniel Zivan

Attachment: Original and sixteen copies

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Service List for: Arizona Public Service Company
Docket No. E-01345A-05-0520

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**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

ARIZONA PUBLIC SERVICE COMPANY

DOCKET NO. E-01345A-05-0520

NOTICE OF INTENT TO INCREASE EQUITY

SEPTEMBER 30, 2005

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Public Service Company Docket No. E-01345A-05-0520 was the responsibility of the Staff member listed below: Daniel Zivan was responsible for the review and financial analysis of the Company's application.

A handwritten signature in black ink, appearing to be 'DZivan', is centered on the page.

Daniel Zivan
Public Utilities Analyst I

**EXECUTIVE SUMMARY
ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. E-01345A-05-0520**

Arizona Public Service Company ("APS"), an Arizona "C" Corporation located in Phoenix, Arizona, filed, as required by A.A.C. R14-2-803, a notice of intent to increase equity with the Arizona Corporation Commission ("Commission") on July 22, 2005.

APS intends to increase its equity with a \$450 million equity infusion from its parent, Pinnacle West Capital Corporation ("PNW"), in order to improve its credit ratings and financial stability. A.A.C. R14-2-803 requires APS, a Class A utility, to notice the Commission of its intent to "reorganize." Decision No. 58063, dated November 3, 1992, provides a \$100 million per year exemption from the notice requirement. APS has already received a \$100 million equity infusion from PNW in 2005. APS' filing provides notice to the Commission that it intends to receive an additional \$350 million of investments from PNW. A.A.C. R14-2-803.C provides that, ". . . the Commission may reject the proposal if it determines that it would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service."

PNW issued \$250 million of common stock equity in May 2005 and invested \$100 million of the proceeds in APS. PNW intends to invest the remaining \$150 million into APS unless the Commission rejects its reorganization proposal. GenWest, L.L.C., a wholly owned subsidiary of PNW, is in the process of selling its Silverhawk power plant in Nevada for approximately \$200 million. The sale is expected to be finalized in the fourth quarter of 2005 and all proceeds would be invested into APS.

APS's existing capital structure consists of 9.1 percent short term debt, 45.8 percent long term debt and 45.1 percent equity. APS's pro forma capital structure reflecting the proposed \$450 million equity investment is 8.4 percent short term debt, 42.0 percent long term debt and 49.7 percent equity. The proposed equity investment would strengthen APS's capital structure and increase its ability to obtain more favorable future financing. Staff finds no basis to reject APS' recapitalization plan. No determination of the ratemaking treatment of the equity infusion is necessary or appropriate in this docket.

Staff recommends approval of the reorganization.

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SCHEDULES

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Introduction

On July 22, 2005, Arizona Public Service Company ("APS"), an Arizona "C" Corporation located in Phoenix, Arizona, filed, as required by Arizona Administrative Code ("A.A.C.") R14-2-803, a notice of intent to increase equity with the Arizona Corporation Commission ("Commission"). APS' parent, Pinnacle West Capital Corporation ("PNW"), intends to invest \$450 million of equity into APS in 2005. The application asks that the Commission permit its notice to expire after 120 days without action by the Commission.

Background

APS is a subsidiary of PNW and provides electric distribution services to approximately 990,000 customers. APS's current rates were approved in Decision No. 67744, dated April 7, 2005. APS has publicly stated that it intends to file a rate application with the Commission later in 2005.

A.A.C. R14-2-803.A states that, "Any utility or affiliate intending to organize a public utility holding company or reorganize an existing public utility holding company will notify the Commission's Utility Division in writing at least 120 days prior thereto." Decision No. 58063, dated November 3, 1992, states that a public utility holding company increasing or decreasing its financial interest in an affiliate would be considered a reorganization and therefore would be subject to A.A.C. R14-2-803. Decision No. 58063 also exempts PNW or APS from the requirement of informing the Commission of any reorganization of an affiliate interest if the investment amount does not exceed \$100 million in one year. APS' application provides notice to the Commission that it has already received an equity infusion from PNW in the amount of \$100 million dollars in 2005 and intends to receive an additional \$350 million.

Purpose of Reorganization

APS intends to increase its equity by approximately \$450 million in 2005. APS states that the equity investment is needed to maintain positive credit ratings and to improve its financial stability. APS plans to use the additional equity to meet the up-front cash demands associated with the customer growth. APS asserts that issuing additional debt to meet these cash needs could have a negative effect on its credit ratings and could result in less favorable terms on future financings. The proposed infusion of equity would improve APS's overall capital structure.

Description of Proposed Reorganization

APS intends to increase its equity through investments by PNW and retention of its earnings. PNW issued \$250 million of common stock equity in May 2005 and has invested \$100 million of the proceeds into APS. PNW plans to invest the remaining \$150 million dollars raised from its stock issuance into APS unless the Commission rejects its recapitalization proposal. GenWest, L.L.C., a wholly owned subsidiary of PNW, is in the process of selling its Silverhawk

power plant in Nevada for approximately \$200 million. All proceeds from the sale would be invested into APS.

Reorganization Analysis

A.A.C. R14-2-803.B states that “The Commission will, within 60 days from the receipt of the notice of intent, determine whether to hold a hearing on the matter or approve the organization or reorganization without a hearing.”¹ A.A.C. R14-2-803.C states that, “. . . the Commission may reject the proposal if it determines that it would impair the financial status of the public utility, otherwise prevent it from attracting capital at fair and reasonable terms, or impair the ability of the public utility to provide safe, reasonable and adequate service.”

Schedule DTZ-1 presents APS’s existing capital structure as of December 31, 2004 and its pro forma capital structure including the proposed \$450 million equity infusion. APS’s existing capital structure consists of 9.1 percent short term debt, 45.8 percent long term debt and 45.1 percent equity. APS’s pro forma capital structure reflecting the proposed \$450 million investment is 8.4 percent short term debt, 42.0 percent long term debt and 49.7 percent equity.

Moody’s and Standard & Poor’s have issued bulletins stating that the outlook for APS’ credit ratings have been upgraded from negative to stable as a result of APS’s recent rate case and the planned equity infusion.

Compliance

There are no compliance issues in relation to APS Decision No. 58063.

Staff Conclusions and Recommendations

Staff concludes that the proposed equity infusion would strengthen APS’s capital structure and increase its ability to obtain more favorable future financing and that there is no basis under A.A.C. R14-2-803.C. to reject APS’ recapitalization plan.

Staff further concludes that no determination of the ratemaking treatment of the equity infusion is necessary or appropriate in this docket.

Staff recommends approval of the reorganization.

¹ Staff and APS jointly requested that the Commission adopt a schedule to govern this case that requires Staff to file a report by September 30, 2005 and the Hearing Division to prepare a proposed order in time for the Commission to consider this matter at an open meeting held on or before December 6-7, 2005.

FINANCIAL ANALYSIS

Selected Financial Data
Including Immediate Effects of the Increase of Equity

	[A] <u>12/31/2004</u>	In 000's	[B] ¹ <u>Pro Forma</u>	
Short-term Debt	\$451,247	9.1%	\$451,247	8.4%
Long-term Debt	\$2,267,094	45.8%	\$2,267,094	42.0%
Common Equity	\$2,232,402	45.1%	\$2,682,402	49.7%
Total Capital	\$4,950,743	100.0%	\$5,400,743	100.0%

¹ 2004 actual financial information adjusted to reflect the proposed \$450 million equity infusion