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Commissioner Kristin K. Mayes
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007-2996

RE: APS Rate Case; Docket No. E-01345A-05-0816

Dear Commissioner Mayes:

Arizona Public Service Company ("APS" or "Company") is responding to the matters raised in your letter of November 16, 2005.[1] I will begin by addressing your questions about the pension plan shortfall including how we find ourselves in this situation and why we are now seeking accelerated recovery of these costs from customers.

When it is said that a pension fund is "underfunded," it does not mean that it is currently running a deficit or that future pension benefits will not be paid. It does mean that the present value of future pension liabilities exceeds the present amount in the pension fund. Similarly, if a pension fund is "overfunded," APS cannot simply declare the excess to be "earnings" and use them for dividends or any purpose other than meeting future pension obligations. This understood, APS takes its responsibility with respect to its pension plan very seriously and understands how important the Company's pension plan is to the retirement security of approximately 12,000 current and former employees and their families – the vast majority of whom are Arizonans. Historically, this Commission has supported this goal, and to my knowledge, the inclusion of employee pension liabilities in cost of service for ratemaking

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[1] APS wishes to clarify some possible confusion between the situation affecting employee benefits as a whole and the specific facts involving pension benefits. Your letter states: "According to APS testimony, the under-funded pension's deficit is due to escalating medical costs and reduced interest rates, which have negatively impacted the performance of the pension fund investments." The letter goes on to reference page 23 of the Direct Testimony of Ms. Laura Rockenberger. On that page, Ms. Rockenberger is referring to the pro forma adjustment for <u>all</u> employee benefits, whereas, page 24 of Ms. Rockenberger's testimony addresses the pro forma adjustment for accelerated recovery of the underfunded pension liability. The statements on page 23 of the testimony explaining the need for the pro forma adjustment for employee benefits combined in one sentence the explanations for both pension expense and for Other Post-retirement Employee Benefit ("OPEB") plans. However, OPEBs are primarily retiree medical benefits, which are significantly influenced by rising medical costs. In contrasts, escalating medical costs have no direct impact on pension expense.

purposes has never been an issue in APS rate proceedings, including the allowance requested for such liabilities in our last rate docket, which resulted in Decision No. 67744.

During the years 2000 through 2005, the Company contributed $228.5 million to the pension plan. In each of these years, the Company contributed more than the contribution required by the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code. Such excess contributions total $120.5 million.

Although APS did include pension costs in its last rate filing without objection from any party or the Commission, it did not seek accelerated funding of the underfunded amount in the Company's last rate case. At the time the last rate case was filed (June 2003), the substantial underfunded status was a relatively recent phenomena, and the Company, at that time, did not have the perspective to evaluate whether the underfunded status was a transitory or persistent situation. As can be seen in the following table, the underfunded percentage escalated rapidly over the years 2001 and 2002, and has since then remained relatively steady at about 30% underfunded:

	12/31/00	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05
% Underfunded	3%	14%	32%	29%	28%	30%[2]

Pension funding status is based on the difference between the assets in the pension plan and the present value of future benefit payments that the assets are expected to fund. Funding status can change if either the plan assets or the pension liabilities change.

Consistent with ERISA's prudent diversification requirement, pension assets are allocated among six (6) diversified investment classes as follows:

Asset Class	Percentage
Domestic Large Cap Equities	42%
Domestic Small Cap Equities	6%
International Equities	12%
Domestic Fixed Income	24%
International Fixed Income	6%
Real Estate	10%

During the three years 2000 through 2002, Company pension plan investment returns were substantially below normal, long-term expected returns. Investment return for 2000 was a relatively flat +1%, while in 2001 and 2002, the plan posted net investment losses of −2.7% and −4.4%, respectively. The bear market from March 2000 to October 2002 was the worst downturn

[2] Estimated based on financial market conditions on 12/15/05

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in stock prices in 25 years. However, despite unfavorable market conditions, the performance of our pension plan has continued to compare very favorably versus the median return of 250 U.S. corporate pension plans ("Peer Group"), and the total return of the S&P 500 index, as shown in the following table:

	2000	**2001**	**2002**	**2003**	**2004**	**Year to date 10/31/05**
APS Plan	1.0%	-2.7%	-4.4%	23.3%	12.3%	3.6%
Peer Group[3]	0.3%	-3.8%	-9.3%	22.3%	11.6%	N/A
S&P 500	-9.1%	-11.9%	-22.1%	28.7%	10.9%	1.1%

Pension liabilities are calculated by making actuarial projections for the plan's future payments to participants, then discounting these amounts back to the present. The lower the discount rate, the higher the liabilities. The discount rate for determining funding status under generally accepted accounting principles is based on corporate bond yields as specified in FAS-87[4].

Standard & Poor's, in its July 18, 2005 report titled, ***S&P 500 2004 Pension Status Report***, stated: "In recent years, as interest rates fell to the lowest levels in 40 years, pension liability discount rates fell and liabilities surged. This was a major factor in the deterioration of corporate pension plans."

In conclusion, a number of factors have contributed to the current pension funding shortfall. Barring the accelerated recovery of the underfunded pension liability as proposed in APS' application, the pension funding situation is not expected to improve in the near future. And because pension costs have always been recognized as a legitimate cost of service for ratemaking purposes by this and every other regulatory commission of which I am aware (absent a showing of imprudence in the management of pension fund assets), it would be inappropriate to now suggest that shareholders fund without compensation this or any other cost of providing utility service to our customers.

I hope this letter has addressed the issues raised by your letter. As the discovery process unfolds in the pending rate proceeding, I believe that your Staff and other interested parties will gain additional insights into this matter, which as I have indicated in this letter, is a national phenomena.

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[3] Median rate of return of approximately 250 U.S. corporate pension plans, Source: State Street Bank & Trust Co.

[4] Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions (Issued December 1985)

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Sincerely,

Thomas L. Mumaw

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Parties of Record

APS • APS Energy Services • Pinnacle West Energy • SunCor • El Dorado

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