



ORIGINAL



0000040073

A subsidiary of Pinnacle West Capital Corporation

Steven M. Wheeler  
Executive Vice President  
Customer Service & Regulation

D6

January 31, 2006

Jeff Hatch-Miller, Chairman  
William A. Mundell, Commissioner  
Marc Spitzer, Commissioner  
Mike Gleason, Commissioner  
Kristin K. Mayes, Commissioner  
ARIZONA CORPORATION COMMISSION  
1200 West Washington Street  
Phoenix, Arizona 85007

RECEIVED  
2006 JAN 31 P 4: 51  
AZ CORP COMMISSION  
DOCUMENT CONTROL

**Re: Arizona Public Service Company Revised Rate Filing;  
Docket No. E-01345A-05-0816**

Dear Commissioners:

**Introduction**

Arizona Public Service Company ("APS" or "Company") has today filed a revision to its November 4, 2005 rate case application in the above docket. The revision changes the Company's requested rate increase to approximately \$454 million, or 21.3%, based on an updated test period of the twelve months ended September 30, 2005. This compares to the 19.9% (\$409.1 million) increase reflected in our November 4, 2005 Application.

This is **not** an additional rate request but an update to (and replacement of) our November filing. Pure and simple, the dominating factor remains escalating and volatile fuel and purchased power costs, which now constitute approximately \$300 million or two-thirds of the requested increase in base rates. Raising our base fuel rate to reflect today's costs is essential to our ability to serve our growing customer needs. The purpose of this letter is to offer an overview of several key aspects of our revised filing that may aid you in its timely review.

**Amount of the Revised Increase**

Although the dollar amount of the Company's revenue deficiency has increased by some \$44.8 million, the updated request will not impose **any** additional costs on our customers compared to the original November application. This is because the increase in base fuel costs will reduce the size of future PSA adjustments and/or surcharges. Non-fuel related revenue requirements have actually decreased by \$7.4 million in our updated filing.

The \$44.8 million increase in test period revenue requirements has the following fundamental components:

ARIZONA PUBLIC SERVICE COMPANY						
Rate Request Comparison						
	1/31/06 Filing		11/14/06 Filing		Change for Test Year Update	
	Increase (Millions)	Percent Increase	Increase (Millions)	Percent Increase	Increase (Millions)	Percent Increase
Fuel and purchased power costs	\$ 468.2		\$320.4		\$147.8	
Hedge value	(169.2)		(73.6)		(95.6)	
Net fuel and purchased power costs	299.0	14.0%	246.8	12.0%	52.2	2.0%
All other	154.9	7.3%	162.3	7.9%	(7.4)	-0.6%
Total Revenue Requirement	\$ 453.9	21.3%	\$409.1	19.9%	\$44.8	1.4%

### Cost Management

The costs sought to be recovered in our rate filing reflect aggressive and highly effective cost management practiced over a period of many years. Cost management is an on-going and fundamental business goal that permeates the entire Company, starting with the President and extending to every APS employee and through every business function. These efforts are not only reflected in the current filing but will continue to benefit customers for years to come. We are and will remain committed to excellence in every facet of our operations. This includes high levels of operating performance, managing risks and costs, and providing reliable service to our customers at reasonable prices. Attached to this letter are two charts illustrating the success of our efforts.

Inflation is a fact of life faced by every business, including ours. If APS' total cost of service in 1995 had just increased by the general rate of inflation, we would now be experiencing a unit cost of 12 cents per kWh. Yet our actual 2005 cost was only 9.8 cents per kWh or an 18.3% reduction in real terms. This reduction in the cost of electricity happened despite the fact that volatile fuel and purchased power costs, over which APS has little control, actually increased by 85% (44% over the rate of general inflation during this same period) and continue to increase in 2006. The Company's aggressive cost management efforts were able to partially offset this increase by a decline in our other (non-fuel) costs of 12% (31% adjusted for inflation). These measures demonstrate both the effectiveness of our cost management process in the areas over which management has a greater ability to

control costs and the inexorable rise in fuel prices despite an aggressive hedging program and other prudent fuel management practices.

I would also add that this cost management has not come at the expense of customer service and satisfaction, both of which have increased during this same period. According to a recent J.D. Power survey, APS is among the highest ranked investor-owned electric utilities in the country in terms of customer satisfaction and number one out of such utilities in the western region. These results could not have been obtained without the sustained efforts of all APS employees to manage costs while enhancing value for our customers.

Despite the obvious success the Company has had in controlling its overall costs, there have been issues raised regarding the appropriateness of including some specific costs in customer rates. I would next like to address these issues.

#### **Exclusion of Certain Costs**

Fuel and purchased power costs account for roughly two-thirds of our updated request, but I also would like to state what is not included in that request. These include: (1) officer performance incentive pay, which is one of the important tools we have used to reduce costs, improve management performance and retain high quality management; (2) officer base salary increases in 2005; (3) over \$6 million in APS advertising, including all of its sponsorships and promotional messages; (4) all charitable donations; (5) public affairs and community relations costs not directly related to a customer benefit; and (6) economic development costs not directly benefiting APS customers. APS has excluded these costs because they either represent costs APS has never charged to customers or reductions that we made in this specific filing to reduce the overall impact on our customers.

#### **Shareholder Contribution**

APS and its shareholders have contributed quite significantly for the benefit of our customers. Specifically, and aside from not including some expense items described above in its cost-of-service, APS has earned approximately \$220 million **less** than its Commission-authorized return since 2001. APS will absorb more than \$45 million of legitimate fuel and purchased power costs through 2006 as a result of the 90/10 sharing provisions of the PSA – an absorption of costs not asked of any other Arizona utility with a fuel or purchased gas adjustment mechanism. Shareholders have also infused over \$450 million of additional equity into APS during the past 12 months to shore up the Company's balance sheet – a move that was absolutely necessary to provide APS with critical cash resources for its operations - even though there is no opportunity for that equity to earn a compensatory return until well after the present rate proceeding is concluded.

**Conclusion**

We are proud of our past achievements, our present provision of quality service to customers, and our future plans to meet an absolutely vital and ever growing responsibility to our customers and the Arizona communities in which they live and work. As this rate case proceeds to a final decision, we look forward to continuing the dialogue with you and with our customers about the important issues this case presents to the Commission and the impact our filing will have on the energy future of Arizona.

Sincerely,



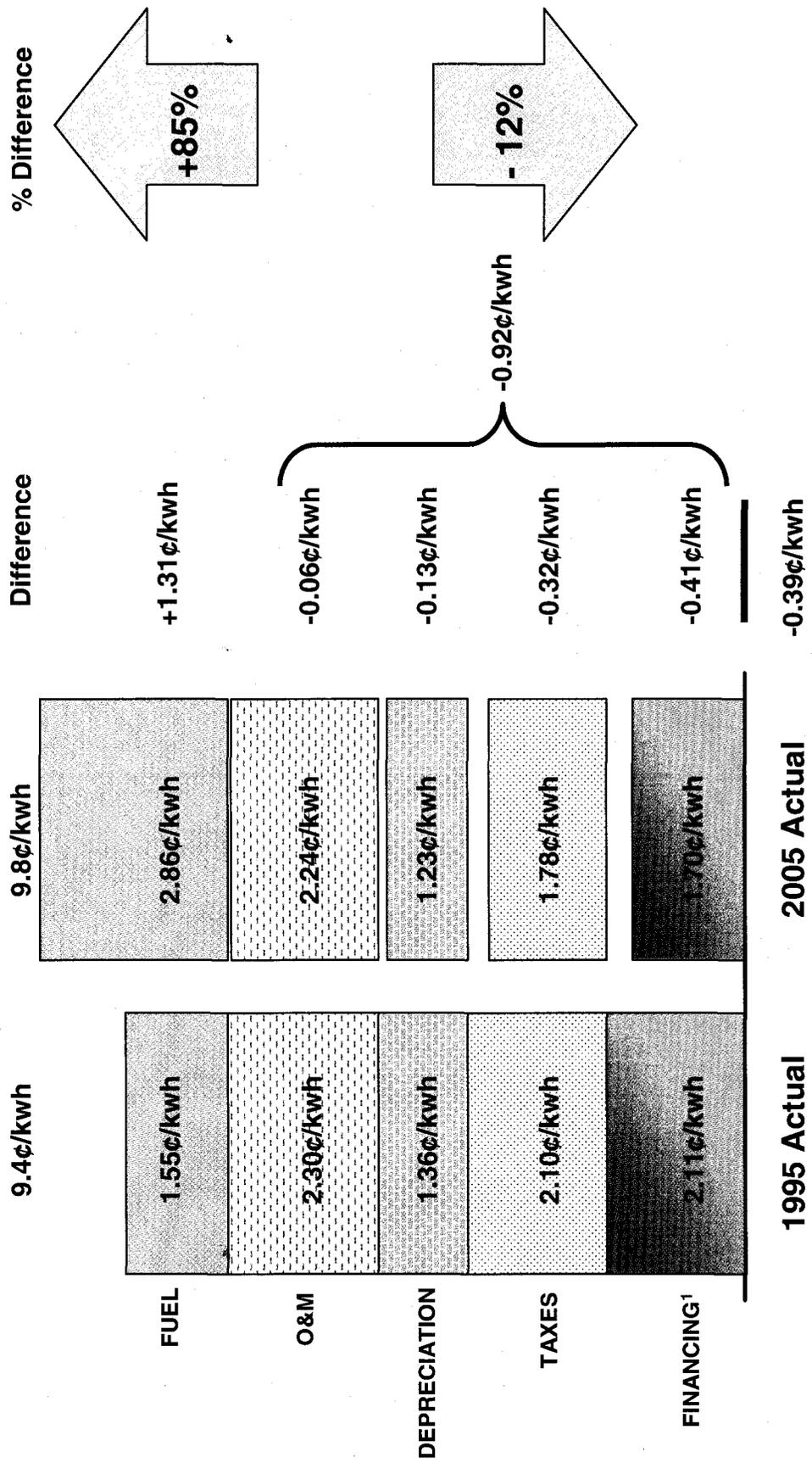
Steven M. Wheeler

Enclosure

cc: Parties to the Docket;  
Original and 13 copies to  
Docket Control

# Arizona Public Service Company

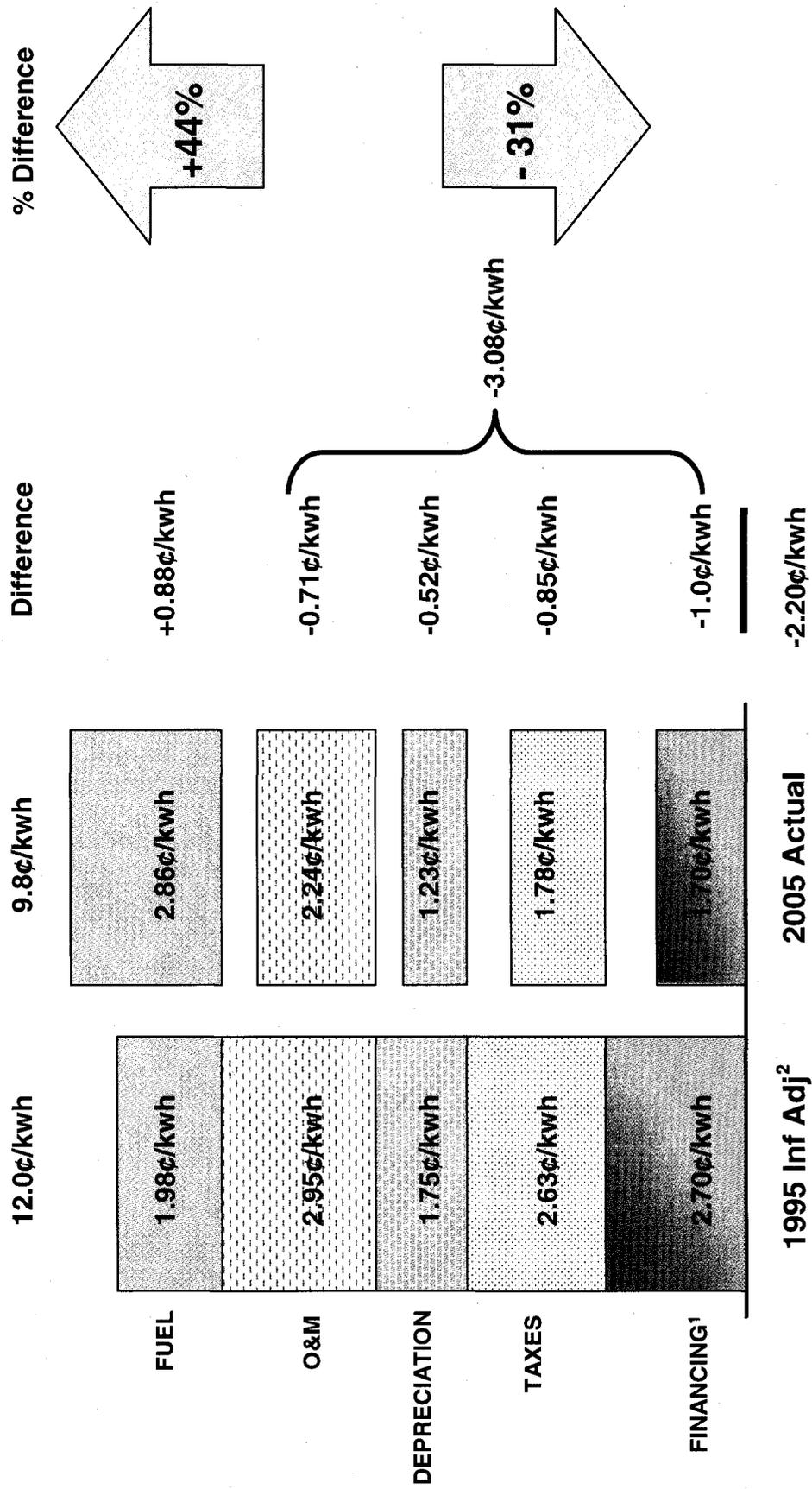
## Cost per kwh Comparison



<sup>1</sup>Includes both debt and shareholder financing costs

# Arizona Public Service Company

## Cost per kwh Comparison



<sup>1</sup> Includes both debt and shareholder financing costs

<sup>2</sup> 1995 \$ inflated to 2005 using CPI index

<u>Docket Numbers for Vicki</u>	
Interim Rate Increase & Amendment to Dec. 67744	E-01345A-06-0009
Transwestern - Natural Gas Infrastructure	E-01345A-05-0895
Access Improvement Plan	E-01345A-05-0883
Prudence Review - Fuel & Purchased Power	E-01345A-05-0827
Prudence Review - PV Unplanned Outages	E-01345A-05-0826
2005 General Rate Case	E-01345A-05-0816
Bill Estimation - Schedule 8	E-01345A-05-0711
Residential TOU - ET-2 & ECT-2	E-01345A-05-0674
	E-01345A-05-0526
Power Supply Adjustor Surcharge (PSA)	E-01345A-03-0437
DSM Portfolio Plan	E-01345A-05-0477
DSM High Efficiency Consumer Products	E-01345A-05-0429
DSM Energy Wise	E-01345A-05-0414
EPS Credit Contracts	E-01345A-05-0373
DSM Study	E-01345A-05-0182
Commercial Facility Mgr Training (DSM)	E-01345A-04-0278
Commercial Power Partners Volunteers (DSM)	E-01345A-04-0277
ED-3 Sale	E-01345A-02-0285
Resource Planning Workshop	E-00000E-05-0431
Distributed Generation Workshop	E-00000A-99-0431
Generic Electric Restructuring Issues and Independent Scheduling	E-00000A-02-0051 E-00000A-01-0630
Rate Increase	E-01933A-04-0408
Amendment to Dec. 62103	E-01933A-05-0650
Adjustment to Purchased Gas Adjustor Surcharge (PGA)	G-04204A-05-0596
Rate Increase	G-01551A-04-0876

Proposed Rule - EPS -

RE-000000-05-0030

Out of - State Renewables - E-01345A-05-0675