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NOV 14 2002

ARIZONA CORPORATION COMMISSION
HEARING DIVISION

TO: THE COMMISSION

FROM: Utilities Division

DATE: November 14, 2002

RE: IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE CO. FOR A WAIVER OF ARIZONA ADMINISTRATIVE CODE R14-2-804(B)(1) AND (2) (DOCKET NO. E-01345A-02-0840)

On November 8, 2002, Arizona Public Service Co. ("APS" or "Company") filed an application for a waiver of Arizona Administrative Code ("A.A.C.") R14-2-804(B)(1) and (2) (the "Rules"). Specifically, APS seeks to make short-term advances of funds to its parent, Pinnacle West Capital Corporation ("Pinnacle West"), or to make short-term guarantees of Pinnacle West's debt, as more fully described below.

The financing statutes would allow APS to execute this transaction without Commission approval but for Rule 804, one of the Commission's affiliated interests rules. Those rules state in relevant part:

> R14-2-804. Commission Review of Transactions Between Public Utilities and Affiliates
>
> B. A utility will not consummate the following transactions without prior approval by the Commission:
>
> 1. Obtain a financial interest in any affiliate not regulated by the Commission, or guarantee, or assume the liabilities of such affiliate;
>
> 2. Lend to any affiliate not regulated by the Commission, with the exception of short-term loans for a period less than 12 months in an amount less than \$100,000...[1]

and

> R14-2-806. Waiver from the Provisions of this Article
>
> A. The Commission may waive compliance with any of the provisions of this Article upon a finding that such waiver is in the public interest.

[1] Rules 804 and 806 were adopted in 1990 as part of the Commission's affiliated interest rules. The Commission stayed these rules shortly after their adoption in anticipation of litigation. In 1992, the Arizona Supreme Court issued an opinion upholding the Commission's authority to adopt the rules. Shortly thereafter, the Commission lifted the stay. <u>See</u> Decision No. 58063 (November 3, 1992). The Commission, however, did not completely lift the stay, so portions of Rule 804 are still subject to a partial stay. For purposes of this case, the relevant portions of Rule 804(b)(1) have <u>not</u> been stayed. Decision No. 58063 at 4. By contrast, relevant portions of Rule 804(b)(2) may be subject to the partial stay. Decision No. 58063 at 5.

The full text of rules 804 and 806 is set forth in Exhibit 1.

APS intends to loan Pinnacle West up to an aggregate principle amount of $125,000,000 for a period of up to 364 days ("Backup Line of Credit") or to guarantee Pinnacle West debt up to an aggregate principle amount of $125,000,000 ("Interim Guarantee") for the same period. APS wants to undertake these obligations because Pinnacle West recently lost the ability to renew a $125,000,000 364-day bank facility ("Bank Facility") that was used to support Pinnacle West's commercial paper program. The Bank Facility expires November 29, 2002. The commercial paper program funds Pinnacle West's ongoing operations. Commercial paper programs are normally backed by some form of credit, such as the expiring Bank Facility, and loss of such backup would normally result in loss of an ability to sell commercial paper in the same amount.

Staff confirmed that Pinnacle West is expected to suffer liquidity problems if it was unable to access its full commercial paper program, including the $125,000,000 commercial paper or similar program. Pinnacle West needs the credit facility or a similar cash source to manage its cash flows over the next year. Without access to these or similar sources, Pinnacle West's cash flow will likely become negative relatively soon.

The application states that the Backup Line of Credit or Interim Guarantee is necessary to stabilize the financial condition of Pinnacle West and its affiliates and to avoid rating downgrades. On November 4, 2002, Standard & Poor's Ratings Services ("S&P") lowered APS' corporate credit rating to BBB from BBB+. The downgrade was the result of S&P's consolidating the ratings of APS and Pinnacle West because of a lack of regulatory insulation between the two entities.

APS' application asserts that it will not be required to borrow funds to finance either the Backup Line of Credit or the Interim Guarantee and that neither would result in a loss of APS' overall credit quality or debt rating or in any manner adversely affect APS customers. The application further indicates that APS would avoid further deleterious financial consequences through Pinnacle West if the application was granted and APS was allowed to support its parent through the Backup Line of Credit or the Interim Guarantee.

APS asserts that "it is making this emergency request to address a deteriorating financial situation arising from the Arizona Corporation Commission's ("Commission") dramatic "reversal of course" on divestiture of generation assets by APS and the necessary integration of APS and Pinnacle West Energy Corporation ("PWEC") generation as called for under the 1999 APS Settlement Agreement and the Commission's Electric Competition Rules." Contrary to APS' assertions, Staff believes that the exigent circumstances are due to market conditions quite apart from any Arizona action. Those market conditions include a reduction in credit extended to the energy industry generally. See Exhibit 2 for articles on the current credit situation. The article "Energy Industry's Debt Is Long-Term Problem" from *The Wall Street Journal* states that a Standard & Poor's report concludes that a combination of factors makes this one of the worst times in recent history to refinance debt [for the energy industry]. *The Washington Post* article

"A Shock to the System" reports that "[S]ince July, S&P has downgraded credit ratings on 57 power companies, compared with nine downgrades in the same period a year ago." The article "Electric Industry Hits Credit Crisis" from *The Wall Street Journal* indicates that in the first nine months of 2002 there were 135 credit downgrades of utility holding companies and their subsidiaries. The article states,

> "Utility companies, electric and gas, are carrying big debt loads piled on in the late 1990s as companies prepared for energy industry deregulation. More recently, they have suffered from lower cash flow after wholesale energy prices collapsed. The result is that companies are finding it more difficult and more expensive to roll over debt and to complete costly new generation and transmission projects."

In Staff's assessment, the situation described by APS presents an exigent circumstance, especially when viewed in the context of the energy sector as a whole. Failing to address the liquidity problem at Pinnacle West could cause significant problems for APS. Because of this risk and because of the attendant turmoil currently surrounding the energy industry, Staff believes that prompt action by the Commission is appropriate. Staff believes that the limited size and duration of the request weighed against the potential harm that could accrue to APS indicates that the waiver is in the public interest.

Finally, Staff believes that granting this application will preserve the status quo without prejudicing the Commission's ability to evaluate the pending APS financing application. Staff's recommendation to approve this waiver application is not intended to indicate a position regarding the pending financing application in Docket No. E-10345A-02-0707.

Staff further believes that the lack of regulatory insulation between APS and Pinnacle West has the potential to result in APS suffering further deleterious derivative financial consequences, such as rating downgrades, if Pinnacle West suffered liquidity problems. For these reasons, Staff recommends that the Commission examine methods for improving the regulatory insulation between APS and its affiliates in the pending financing application.

Staff recommends that APS be granted a waiver of Rule 804(B)(1) and, to the extent necessary, Rule 804(B)(2) subject to the following four conditions:

(1) The pricing schedule between Pinnacle West and APS for the Backup Line of Credit shall be the existing pricing schedule on the expiring Bank Facility at Level IV status (or Level V if Pinnacle West's ratings fall below either BBB- by S&P or Baa3 by Moody's). Other terms and conditions of the Backup Line of Credit shall be the same as the expiring Bank Facility.

(2) APS shall acquire a $125,000,000 security interest in certain Pinnacle West Energy Corp. assets.

(3) All revenues received by APS pursuant to this authority shall be deferred and accounted for in a manner to allow amortization as a credit to customers in the next rate case.

(4) The Commission shall examine methods for improving the regulatory insulation between APS and its affiliates in the pending financing application.

These conditions are designed to ensure that APS' ratepayers will be adequately protected from any potential risk associated with this transaction.

Staff recommends approval of the application without a hearing.

If the Commission does not act on this matter before December 8, 2002, APS' request for a waiver will be granted by operation of law. Accordingly, if the Commission wishes to set this matter for hearing or to otherwise delay acting upon this application, it will be necessary to suspend it pursuant to A.A.C. R14-2-806(C).

Ernest G. Johnson
Director
Utilities Division

EGJ:JST

ORIGINATOR: John S. Thornton, Jr.

CC: Parties of record, Docket No. E-01345A-02-0707

Exhibit 1

ARIZONA ADMINISTRATIVE CODE
TITLE 14, ARTICLE 8
PUBLIC UTILITY HOLDING COMPANIES
AND AFFILIATED INTERESTS

Historical Note

Adopted effective July 30, 1992 (Supp. 92-3).

R14-2-804. Commission Review of Transactions Between Public Utilities and Affiliates

A. A utility will not transact business with an affiliate unless the affiliate agrees to provide the Commission access to the books and records of the affiliate to the degree required to fully audit, examine or otherwise investigate transactions between the public utility and the affiliate. In connection therewith, the Commission may require production of books, records, accounts, memoranda and other documents related to these transactions.

B. A utility will not consummate the following transactions without prior approval by the Commission:
   1. Obtain a financial interest in any affiliate not regulated by the Commission, or guarantee, or assume the liabilities of such affiliate;
   2. Lend to any affiliate not regulated by the Commission, with the exception of short-term loans for a period less than 12 months in an amount less than $100,000; or
   3. Use utility funds to form a subsidiary or divest itself of any established subsidiary.

C. The Commission will review the transactions set forth in subsection (B) above to determine if the transactions 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.

D. Every transaction in violation of subsection (A) or (B) above is void, and the transaction shall not be made on the books of any public service corporation.

E. The system of accounts used by the public utility will include the necessary accounting records needed to record and compile transactions with each affiliate.

Historical Note

Adopted effective July 30, 1992 (Supp. 92-3).

R14-2-805. Annual Filing Requirements of Diversification Activities and Plans

A. On or before April 15th of each calendar year, all public utilities meeting the requirements of R14-2-802 and public utility holding companies will provide the Commission with a description of diversification plans for the current calendar year that have been approved by the Boards of Directors. As part of these filings, each public utility meeting the requirements of R14-2-802 will provide the Commission the following information:
   1. The name, home office location and description of the public utility's affiliates with whom transactions occur, their relationship to each other and the public utility, and the general nature of their business;
   2. A brief description of the business activities conducted by the utility's affiliates with whom transactions occurred during the prior year, including any new activities not previously reported;
   3. A description of plans for the utility's subsidiaries to modify or change business activities, enter into new business ventures or to acquire, merge or otherwise establish a new business entity;
   4. Copies of the most recent financial statements for each of the utility's subsidiaries;
   5. An assessment of the effect of current and planned affiliated activities on the public utility's capital structure and the public utility's ability to attract capital at fair and reasonable rates;
   6. The bases upon which the public utility holding company allocates plant, revenue and expenses to affiliates and the amounts involved; an explanation of the derivation of the factors; the reasons supporting that methodology and the reasons supporting the allocation;
   7. An explanation of the manner in which the utility's capital structure, cost of capital and ability to raise capital at reasonable rates have been affected by the organization or reorganization of the public utility holding company;
   8. The dollar amount transferred between the utility and each affiliate during the annual period, and the purpose of each transfer;
   9. Contracts or agreements to receive, or provide management, engineering, accounting, legal, financial or other similar services between a public utility and an affiliate;
   10. Contracts or agreements to purchase or sell goods or real property between a public utility and an affiliate; and
   11. Contracts or agreements to lease goods or real property between a public utility and an affiliate.

B. After reviewing the diversification plans, the Commission may, within 90 days after plans have been provided, request additional information, or order a hearing, or both, should it conclude after its review that the business activities 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.

Historical Note

Adopted effective July 30, 1992 (Supp. 92-3).

R14-2-806. Waiver from the Provisions of this Article

A. The Commission may waive compliance with any of the provisions of this Article upon a finding that such waiver is in the public interest.

B. Any affected entity may petition the Commission for a waiver by filing a verified application for waiver setting forth with specificity the circumstances whereby the public interest justifies noncompliance with all or part of the provisions of this Article.

C. If the Commission fails to approve, disapprove, or suspend for further consideration an application for waiver within 30 days following filing of a verified application for waiver, the waiver shall become effective on the 31st day following filing of the application.

Historical Note

Adopted effective July 30, 1992 (Supp. 92-3).

ARTICLE 9. CUSTOMER-OWNED PAY TELEPHONES

R14-2-901. *Definitions*

In this Article, unless the context otherwise requires:
   1. "Affiliate" means any other entity directly or indirectly controlling or controlled by, or under direct or indirect common control with, a customer of record. For purposes of this subsection, the term "control, (including the correlative meanings of the terms "controlled by" and "under common control with"), as used with respect to any entity, means the power to direct the management policies of such entity, whether through the ownership of voting securities, by contract, or otherwise.
   2. "Customer of record" means a premises owner or vendor, who has either applied to, or who has obtained from, an LEC an access line to be a COPT provider.
   3. "Customer-owned pay telephone (COPT) provider" means an entity authorized by the Commission to provide public pay telephone service to end-users and which is not a certificated LEC on the effective date of this Arti-

Exhibit 2

NEWS ARTICLES ON ENERGY INDUSTRY CREDIT

THE WALL STREET JOURNAL. ONLINE

November 6, 2002

CREDIT MARKETS

Energy Industry's Debt Is Long-Term Problem

By KATHRYN KRANHOLD
Staff Reporter of THE WALL STREET JOURNAL

A credit crisis engulfing much of the country's energy industry isn't likely to let up until at least the end of 2006, during which time about two dozen power companies will scramble to refinance $90 billion in short-term debt, according to research by Standard & Poor's.

The report maintains many of the companies won't be able to obtain new financing, possibly leading to a new wave of loan write-offs for banks, coming on the heels of already-sizable losses on loans to the telecommunications and cable sectors.

Nearly half of the $90 billion borrowed to fund construction projects and acquisitions was financed through bank syndicates, according to the report. Already this week, Toronto-Dominion Bank said it will sharply boost its loan-loss provisions to cover deterioration in the utilities sector, including taking a charge of $169 million to cover unrecoverable loans to three unnamed utilities. **Toronto-Dominion**, one of Canada's five largest banks, is an "early warning of what is going on. This is going to be the next area of significant problems," said Tanya Azarchs, a banking analyst with S&P.

The report doesn't make any changes to energy companies' credit ratings, many of which were downgraded to junk status during the past year by S&P as well as other ratings agencies. Focused on debt exposure, the new report ranks the power companies considered most at risk because a significant portion of their capitalization depends on favorable refinancing by 2006.

Those companies, according to S&P: **Reliant Resources** Inc., **Calpine** Corp., **Mirant** Corp., **PG&E** Corp.'s National Energy Group Inc., and **CMS Energy** Corp. Reliant Resources, for example, needs to refinance $5.9 billion, or about 85% of the Houston company's total debt, the report says. Calpine, of San Jose, Calif., has $7.3 billion of debt that matures by the end of 2006, or about 56% of its debt. CMS, Dearborn, Mich., has $3.9

OTHER RESOURCES

Major Bond Indexes:[2] See statistics on indexes tracking U.S. Treasurys, U.S. corporate-debt issues, mortgage-backed securities and more, updated at the end of the most recent session.

See real-time commentary[3] covering releases, events, and flows affecting the Treasury market, from Briefing.com[4].

COMPANIES

Dow Jones, Reuters

Company	PRICE	CHANGE	U.S. dollars
Reliant Resources Inc. (RRI)	2.02	0.17	11:35 a.m.
Calpine Corp. (CPN)	3.37	0.58	11:37 a.m.
Mirant Corp. (MIR)	2.63	0.33	11:37 a.m.
PG&E Corp. (PCG)	12.00	0.11	11:37 a.m.
CMS Energy Corp. (CMS)	8.27	0.15	11:37 a.m.
Duke Energy Corp. (DUK)	21.84	0.28	11:37 a.m.
TXU Corp. (TXU)	16.13	-0.12	11:37 a.m.

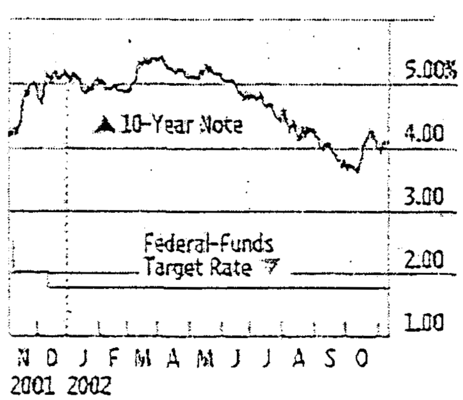
billion coming due. That is 55% of its debt.

* At Market Close

Duke Energy Corp. in Charlotte, N.C., and TXU Corp., in Dallas, have even larger amounts of debt coming due, $8.7 billion and $8.6 billion, respectively, the report states. But Arleen Spangler, a utility analyst at S&P who headed up the joint energy-banking research, said most of their debt is on the books of their regulated utilities and should be easier to refinance because banks trust that the companies won't let those utilities fail.

Rex Clevenger, Reliant's senior vice president of finance, said the company has offered to pledge a pool of assets as security to lenders in order to extend credit facilities. Last week, Reliant refinanced three bank credit facilities for its Orion Power Holdings unit, by giving lenders additional collateral and agreeing to more costly loan terms. "We're trying to work out something where everybody wins here," he said.

TEN-YEAR TREASURY NOTE YIELD



Calpine spokeswoman Katherine Potter said the company has received positive feedback from its lenders during the company's initial discussions with them over the refinancing of $2 billion in credit facilities. A Mirant spokesman declined to discuss negotiations with its lenders, but noted the company paid off $1.2 billion in debt his year and has $1.5 billion in liquidity. A spokesman for PG&E's NEG said the company was continuing to negotiate with lenders but declined to provide specifics.

In general, Ms. Spangler said, the companies can expect to pay higher interest rates and put up hard assets such as plants and pipelines as security to get new financing, in some cases turning over to the bank any cash generated by a plant. She said Reliant is in a better position than some to use its power plants as security for loans. Mirant, AES Corp., based in Arlington, Va., and NEG, on the other hand, are among a handful of companies whose assets already are largely encumbered, making it more difficult to refinance, she said.

Junk-rated Reliant, Calpine, Atlanta-based Mirant, San Francisco-based NEG, and CMS all have negative credit outlooks at S&P. Reliant, Calpine, Mirant and NEG are unregulated power producers and marketers, while CMS is a regulated utility with unregulated power and marketing businesses. Reliant was spun off of what was once known as Reliant Energy Inc., now CenterPoint Energy; Mirant was formerly part of the big Atlanta utility, Southern Co.

Another piece of the S&P research focuses on the financing issues from the perspective of the banks. About $43 billion in bank short-term debt matures by 2006; there is a total of $70 billion of bank loans to the surveyed power companies. The report notes that the banks may have sold down their positions substantially, "though they would generally have kept some portion for themselves."

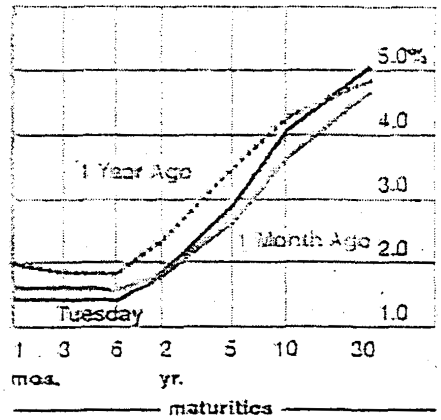
Among the other banks that have syndicated loans for the power industry in the past two years: ABN Amro Holding NV, Bank of America, Bank of Nova Scotia, Barclays Bank SA, BNP Paribas, Citigroup Inc., Commerzbank AG, Credit Lyonnais, Credit Suisse Group, Royal Bank of Scotland, and Societe Generale.

Edison International's power-plant unit, Mission Energy, financed 100% of its $1.8 billion in debt through banks. Reliant Resources has $4.5 billion, or 79%, of its debt with banks. Calpine and a small South Dakota utility, Black Hills Corp., have 75% and 73%, respectively, of their short-term credit facilities with banks.

Banks don't have to disclose their exposure to a specific industry, although some banks have done so, S&P's Ms. Azarchs said. J.P. Morgan Chase & Co. has disclosed it has $2.2 billion in merchant-energy exposure plus another $4 billion in credit lines that haven't yet been drawn upon.

TREASURY YIELD CURVE

Yield to maturity of current bills, notes and bonds.



Source: Reuters

The heavy debt stems from a building-and-acquisition binge that began around 1997. A number of energy companies constructed and bought power plants around the country, aiming to sell electricity into a growing wholesale-power market prompted by deregulation. The companies financed these projects mostly with short-term debt, and figured they would secure longer-term funding once the plants were running and had a track record.

But market conditions have changed significantly since then. An overabundance of power in some regions of the country has led to declining prices, and companies haven't been able to recoup their investments. Companies are postponing projects and canceling equipment orders.

Adding to woes: a slew of federal and state regulatory investigations into many of these energy companies' unregulated natural-gas and electricity-trading operations. These units were the source of much of their revenue growth until earlier this year.

The report states the combination of factors makes "this one of the worst times in recent history to refinance debt."

Treasury Securities

Prices fell on pressure from a $22 billion sale of new Treasury notes and uncertainty over the election outcomes. But prices ended well above their lows of the day, in part because the five-year note auction surprised the market by drawing solid demand. At 4 p.m., the benchmark 10-year note was down 10/32 point, or $3.13 per $1,000 face value, at 102 13/32. Its yield rose to 4.074% from 4.036% Monday, as yields move inversely to prices. The 30-year bond's price was down 12/32 point at 104 12/32 to yield 5.080%, up from 5.057%.

-- Steven Vames of Dow Jones Newswires contributed to this article.

Write to Kathryn Kranhold at kathryn.kranhold@wsj.com[1]

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(4) http://www.briefing.com/wsjie.htm

Updated November 6, 2002

MARKETS DATA AND RESOURCES

Statistical features related to credit markets

- Bond Indexes
- Bond Yields
- DJ Bond Averages
- Federal Reserve Data
- Int'l Government Bonds
- Key Rates
- Money Rates
- Mortgage-Backeds/CMOs
- Treasury Quotes
- BanxQuote Banking Center

washingtonpost.com

A Shock to the System

Electricity Firms Return to Their Roots

By Peter Behr
Washington Post Staff Writer
Tuesday, November 12, 2002; Page E01

Just a few years ago, E. Linn Draper Jr. was leading the charge toward the heady new world of electricity deregulation.

Draper's sprawling energy conglomerate, American Electric Power Co. in Columbus, Ohio, had merged with a big Texas energy company in 2000, becoming one of the nation's biggest U.S. utility owners. It bought power plants as far away as Australia and plunged into electricity trades with Enron Corp. and other power dealers.

Last month, the humbled company chairman was in retreat. At an investors conference in Palm Springs, Calif., Draper offered a different vision for the once highflying AEP. The company's stock has lost half its value this year. It is shutting down its money-losing trading operation, and on Oct. 9 it fired five of its energy traders for falsifying natural gas prices used to set price indexes for the entire industry.

AEP -- like the rest of the nation's battered power industry -- has been forced back to its boring past, to a time when it delivered both electricity and slow, steady growth and predictable returns to its risk-averse investors.

"I hope we have demonstrated that we have stable and traditional earnings and can support the dividend," Draper told the Edison Electric Institute conference in Palm Springs.

Gone is the hype about wresting big profits from deregulated power markets, and debt-financed expansion. The new priorities, as they once were, are cash and dividends.

So goes the turnabout for America's electric companies.

"A lot of people in our industry did things that were ill-advised," said Thomas E. Capps, chief executive of Dominion Resources, Virginia's largest power provider. "A lot of people coming out of a regulated background went into a lot of places they shouldn't have."

The reckoning in the deregulated power markets has had many ill effects, both financial and structural.

About $140 billion in energy investors' holdings has been wiped out, according to Edward Metz, a securities analyst with SNL Financial in Charlottesville.

An unprecedented surge of power-plant construction spawned by optimistic deregulation strategies has left the industry with far too much generation capacity, particularly in the face of a weak economy and stagnant energy growth, analysts agree.

And as much as $50 billion in short-term construction loans that financed the building boom will come due over the next three years, according to the Standard & Poor's bond-rating group. Analysts say it is this debt that will shake out the industry's at-risk companies in the coming years, perhaps creating further upheaval as bankruptcy or forced sales wrack the industry.

"We are in the first year or so of what will be a multi-year bust cycle in the power industry," said Lawrence J. Makovich, senior director of Cambridge Energy Research Associates. "They built too much at too high a cost, and they did it mostly with debt. We are overbuilt in the vast majority of the regional power market, and in the next six months there is a better-than-even chance we'll have a couple of major bankruptcies."

As painful as the industry's fall has been, consumers have not suffered. Retail prices are still controlled in most of the country, even in states -- including Maryland and Virginia -- that are phasing in deregulation plans. With plenty of surplus generating capacity around, there should be little fear of a sharp spike in electricity (although a harsh winter could send heating bills higher).

Although all power companies have suffered from the industry's downturn, some are hurting much worse.

"There is a real divergence of companies," said Peter N. Rigby, a director of S&P's credit-rating group. The firms that took the more cautious approach to deregulation now are in the strongest position. "They stuck to their knitting," Rigby said.

Those that took the biggest risks, spending lavishly on new gas-fired generating plants and launching energy-trading operations, are fighting to survive.

According to S&P, 48 percent of the nation's power companies have a stable credit outlook. "We don't expect things to get worse" for this group, Rigby said. A year ago, 60 percent of the companies were in that category.

Since July, S&P has downgraded credit ratings on 57 power companies, compared with nine downgrades in the same period a year ago.

Currently, 31 percent of the industry has a negative outlook, according to S&P, meaning that credit conditions could worsen. And 15 percent of power companies are on "credit watch" for possible downgrades of their credit rating. (The remainder of the companies are on credit watch for a possible credit upgrade.) In states that adopted deregulation plans, many traditional power utilities chose -- or were required -- to sell their generating plants. The plants were bought by other utilities' deregulated subsidiaries or by a new breed of "merchant" generators, and in many cases the buyers overpaid, said Dominion CEO Capps.

Investment-banking firms sold utility executives on the notion that deregulated power operations could produce returns of 20 percent or more on equity, instead of the traditional returns of 10 to 14 percent. The advice, while alluring, was delivered by the very investment bankers who stood to gain from growth in energy trading, according to Makovich of Cambridge Energy Research Associates. "The people who funded this are the ones to blame," Metz said.

Capps gives thanks every day that he and Dominion didn't make the risky gambles on deregulated power markets here and abroad that many of Dominion's competitors pursued. Dominion bought generation, too, but only when it was certain of selling the output in advance, Capps said. "I don't mean to be cocky," he said. "We were lucky, too."

Power trading was supposed to be a big new profit source for Enron and its imitators, which built costly trading desks staffed with MBA finance whizzes and mathematics gurus who expected to profit from an ever-expanding flow of power deals and the market-driven changes in electricity prices.

But this year's trading scandals and a flurry of federal and state investigations have sent investors fleeing from companies with big trading operations. As their stock prices plunged this summer, they faced growing demands from trading partners to pledge more cash as collateral on long-term energy deals -- cash the companies didn't have. The result: more losses and a sudden, costly exit from trading operations.

Allegheny Energy Inc. in Hagerstown, Md., is in this squeeze. It didn't have the funds to meet collateral demands on its trading operations and defaulted on some contracts. That put the company in technical default on major bank loans and now the company is in do-or-die negotiations with its lenders to refinance $1.3 billion in secured debt and $700 million in working capital.

Making matters worse is a new change in the accounting rules.

Led by Enron, most of the industry adopted "fair value" or "mark-to-market" accounting rules, which permitted them to use current energy prices to record the value of long-term energy supply contracts as current income. That worked handsomely for the traders when energy prices spiked in 2000, but not since power prices fell in the summer of 2001.

Now the accounting industry has decided to bar the practice for energy supply contracts. Companies can record income only when power is delivered. The change will further weaken the financial position of some companies that traded heavily, creating a greater risk of loan defaults, according to Fitch Inc., a bond-rating service.

A comparison of the stock market performance of utility companies this year shows the separation between the stronger and most troubled companies.

Until last month, Wall Street investors treated nearly all power companies like the plague. Stock prices of the Dow Jones utilities group are down an average of nearly 40 percent from their peak in May. But a dividing line between stronger and most imperiled companies has become more pronounced since the second week of October.

Four companies have recovered much of this year's stock market losses -- Southern Co. in Atlanta, Consolidated Edison in New York, FirstEnergy Corp. based in Akron, Ohio, and Exelon Corp. in Chicago. All are long-established energy companies that have kept large transmission networks, low-cost generating plants or both. As power distributors to multi-state franchises of households and businesses, they are assured of a steady stream of customers' cash -- enough to comfortably manage dividend payments.

The Washington area's biggest power supplier, Potomac Electric Power Co., sold its generating plants in preparation for electricity deregulation in the capital region, and its business also rests on a large distribution franchise. The parent company's stock is more than 15 percent below its 2002 peak.

Constellation Energy, which owns generating plants and the Baltimore Gas & Electric Co. distribution network, has climbed back to within

25 percent of its 2002 high mark.

In the middle of group are AEP and Duke Energy in Charlotte -- diversified power companies with solid franchises that also dove into the power-trading business. AEP and Duke's shares are still down by more than 40 percent from 2002 peak levels.

At the bottom of the Dow utility index are two companies, TXU Corp. in Dallas and AES Corp. in Arlington, hit hard because their investments in foreign power operations have gone bad. They are down more than 75 percent from 2002 stock price peaks. Just yesterday, Standard & Poor's warned that if AES is unsuccessful at refinancing $2.1 billion in debt by Dec. 15 it could be forced into a bankruptcy reorganization.

A third group of companies -- Southern's spinoff Mirant Corp. in Atlanta; Reliant Resources Inc. in Houston, and Williams Cos. in Tulsa -- took the biggest gambles on deregulation, buying power plants and launching costly trading operations. With their revenue withered and big debts coming due, the companies are struggling to survive.

It is the outlook for 2005 and beyond that worries some analysts.

"There is very little [new construction] going into the pipeline," said Ken Rose, senior economist with the National Regulatory Research Institute in Columbus. "The problem comes a few years down the line." If plant construction continues to lag but the economy picks up, the demand for power could swell faster than the power industry can respond, he warned. "That could be a serious problem."

Electric Industry Hits Credit Crisis

S&P Reports Downgrades Have Quadrupled This Year Amid Crippling Debt Loads

By Rebecca Smith

The U.S. electric power industry is experiencing its worst credit crunch since the Great Depression and it is only likely to get worse, as billions of dollars of debt will need to be refinanced in coming months.

That is the implication of a report by Standard & Poor's. The credit-rating agency said that in the first nine months of 2002 there were 135 credit downgrades of utility holding companies and their subsidiaries, nearly quadruple the number in the year-earlier period. With nearly one-third of the major companies in the sector on watch for future downgrades, it appears the industry hasn't yet hit bottom.

Utility companies, electric and gas, are carrying big debt loads piled on in the late 1990s as companies prepared for energy-industry deregulation. More recently, they have suffered from lower cash flow after wholesale energy prices collapsed. The result is that companies are finding it more difficult and expensive to roll over debt and to complete costly new generation and transmission projects.

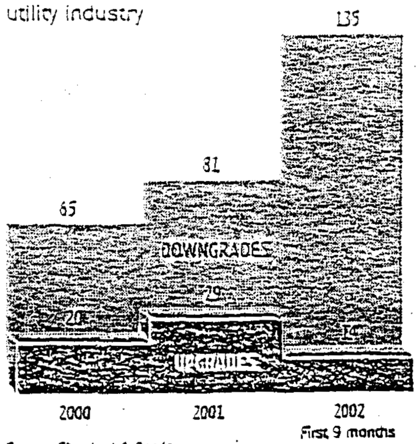
Credit analysts warn that a sustained erosion in funding could eventually crimp the nation's energy supplies, the lifeblood of a modern economy. In coming months, electric-energy firms will attempt to roll over an estimated $50 billion worth of short-term debt. For many companies, the only realistic options will be to pledge more assets as security or pay a higher interest rate—or both.

Tulsa-based Williams Cos., for example, set out to raise badly needed money in August, but the timing proved unfortunate since the company was downgraded twice in July. "We got downgraded at the worst time possible, when we had debt maturities and revolvers coming due," said Williams Treasurer Jim Ivey. "As a result, we had no access to traditional capital markets." The company's below-investment grade rating and single-digit stock price meant it couldn't issue commercial paper, float bonds or sell new shares of stock.

The company wound up borrowing $900 million from Lehman Brothers and Berkshire Hathaway Inc., but was forced to pledge gas reserves as collateral and pay an interest rate of 34% on a one-year loan. "It was better than being insolvent," said Mr. Ivey, acknowledging "lots of people have wanted to second-guess the decision we made" to take out the loan. But, he added, investors and lenders have "given up on this sector."

The Electric Slide

Credit-rating actions in the utility industry



Source: Standard & Poor's

The S&P report said that 11% of the 320 companies included in the report now are rated at "junk" bond levels of double-B-plus or below. Half of the industry now falls in the triple-B category, two notches above a junk rating. "The numbers have been overwhelmingly negative in recent months," said report author Barbara Eiseman in an interview. Of the 135 downgrades so far this year, 57, or 42%, have occurred since July.

The report found that bondholders are less protected now than in the past. Debt represented nearly 60% of the industry's total capital at June 30, the most recent period for which statistics were available, compared with less than 55% four years ago when the industry began gearing up for electricity-markets deregulation. The drive prompted companies to break themselves into different parts, including highly leveraged merchant-generation companies, other specialty companies and traditional regulated utilities. Higher debt levels overall haven't been offset by the fatter revenue anticipated from unregulated, market-driven businesses. As a result, there is proportionately less money available now to cover debt obligations.

Also underlying the current distress was the collapse of industry high-flier Enron Corp. last year, which sowed seeds of mistrust in investors' minds. It worsened amid investor criticism that credit-rating agencies S&P, Moody's Investors Service and Fitch Ratings hadn't been diligent enough in assessing the risk of deregulated electricity markets, and in particular Enron. Moreover, the costly meltdown of California's deregulated power market demonstrated that both big utilities such as Pacific Gas & Electric Co. and independent power producers such as Calpine Corp. could suffer from unanticipated market conditions.

"The industry has pushed a deregulation model that simply hasn't worked," said Peter Rigby, an S&P energy analyst.

Of course, not all utility holding companies are in distress. Exelon Corp., Chicago, which began efforts to whip its balance sheet into shape ahead of the Enron debacle, has an A-minus credit rating, four notches above junk. When one of its utility units sold 10-year bonds early this month, it found receptive investors and had to pay interest of only 4.75%—about one percentage point above the 10-year Treasury note rate. "So far, we have not had problems," said Exelon Chief Executive John Rowe.

In separate credit research, Fitch analyst Richard Hunter said the worst-hit companies have been firms with both regulated utilities and competitive energy supply subsidiaries. "There is a degree of contagion in the minds of the bankers that hurts the whole sector," Mr. Hunter said. With less capital-market support these firms have been forced to sell assets and try to reduce debt levels as best they can.

But even that raises a troublesome question. Asks Mr. Hunter: "If companies are selling their most marketable assets, then where will the cash flow come from in future years? New owners will put pressure on prices, which could further hurt these companies and we could see a deflationary spiral."

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Canadian Union Set to Begin Strike At DaimlerChrysler

By Mark Heinzl

TORONTO—The Canadian Auto Workers union said chances of a strike tonight against the Canadian operations of DaimlerChrysler AG intensified after the company delivered a contract offer that didn't include new investment in a van plant that is scheduled to close next summer.

DaimlerChrysler's stance on the union's demands is "a slap in the face. It's an insult," said CAW President Buzz Hargrove, adding he sees a 95% chance of a strike starting at 11:59 p.m. tonight.

DaimlerChrysler is offering to match the increases to wages and benefits that the union won in recent labor-contract agreements with General Motors Corp. and Ford Motor Co. But DaimlerChrysler has said it hasn't been able to make a business case for a new product to be built at the Pillette Road plant in Windsor, Ontario, which currently makes Dodge Ram vans. The company last year unrolled a North American restructuring plan to reduce capacity.

The plant shutdown jeopardizes about 1,100 jobs. Mr. Hargrove said the company has offered to preserve as many as 65% of those jobs by boosting work-force levels at a nearby separate plant, but that offer has various conditions and the job-creation benefits are unclear.

Mr. Hargrove has voiced pessimism about reaching a strike-free settlement during previous negotiations with auto makers only to announce a breakthrough or compromise as the deadline drew near. But there are some indications the union could walk out on DaimlerChrysler. While Canada is the sole source for a few DaimlerChrysler models, its minivans also are made in the U.S. and analysts said the Canadian union lacks the negotiating leverage with DaimlerChrysler that it had with GM and Ford, which produce several crucial products and parts in Canada.

DaimlerChrysler also is planning about 12 weeks of assembly-line downtime over the next few months to match sagging market demand. A strike would allow the company to save on unemployment-related costs that it would otherwise have to pay.

The union said it has about 51 million Canadian dollars (US$32.1 million) to support striking workers and is prepared for a long walkout.

DaimlerChrysler employs about 12,800 unionized workers in Canada. An assembler earns about C$27.70 an hour on average. In its three-year agreements with GM and Ford, the union won wage increases of 3% in each of the first two years, a 2% increase in the third year, a signing bonus of C$1,000 plus enhancements to paid time off and other benefits.

U.S. Electric Industry Is in a Credit Crisis

Continued From Page A2

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But even that raises a troublesome question. Asks Mr. Hunter: "If companies are selling their most marketable assets, then where will the cash flow come from in future years? New owners will put pressure on prices, which could further hurt these companies and we could see a deflationary spiral."

Rome Might Take Stake in Fiat Auto

Continued From Page A2

GM to buy the 80% of the auto unit it doesn't already own starting in 2004. That option, negotiated as part of a broad alliance between the two companies in 2000, has cast a shadow over GM's balance sheet and weighed on its stock. Under the terms of the 2000 agreement, some major changes to the structure or ownership of the auto unit could void the option.

The latest proposal is one of a number of options the government will start exploring this week, a person close to the government said. Also under consideration is a plan that would re-employ laid-off Fiat workers in other sectors.

Any involvement of the state in Fiat Auto is also likely to be scrutinized by European competition authorities. Speaking to reporters while on a visit to Turin, European Commission President Romano Prodi said Brussels had blocked attempts to help national car industries within the EU "because they did not follow the legislative rules which bind us."

) Denies Ebbers Loans Were Improper

Page A3

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A "financing statement" filed with the Mississippi secretary of state's office refers to a Feb. 15, 2000, amended agreement between Mr. Ebbers' company and Travelers Insurance Co. that covers a $430 million mortgage loan and a $69 million second-mortgage loan. A second financing statement—filed in February 2000 and signed by S. Peter Headly, a Travelers Insurance Co. vice president—refers to a $180 million loan from Travelers Insurance to Joshua Timberlands. Based on those records, the lawsuit alleged that Travelers had lent Joshua Timberlands a total of $679 million in 1999 and 2000.

In its statement, Citigroup said the loan amounts were incorrect. Of the $499 million that Mr. Ebbers' company borrowed in 1999, Citigroup said its Travelers units lent Mr. Ebbers' company $134 million, consisting of an $82 million loan from its Travelers Life and Annuity unit and a $52 million loan from Travelers Property Casualty. Citigroup said it was a participant with three other major insurance companies in lending the $499 million.

A Citigroup executive said the company believes the complaint double-counted the $180 million referenced in the February 2000 financing statement, and that the amount actually was a subset of the $430 million mortgage loan made in 1999. The executive said Travelers structured the $499 million loan package, led the deal, and arranged for the other three insurance companies to participate in the loans.

R. David Kaufman, a lawyer for Mr. Ebbers, said he hadn't yet reviewed the lawsuit and couldn't comment. A WorldCom spokesman declined to comment.

Airbus Wins Large easyJet Order

OpenTV Corp.

Exhibit 3

PROPOSED ORDER AND OPINION

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

IN THE MATTER OF THE EMERGENCY APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A PARTIAL WAIVER OF A.A.C. R14-2-804(B)(1) AND (2)

DOCKET NO. E-01345A-02-0840

DECISION NO.__________

ORDER

Special Open Meeting
November 22, 2002
Phoenix, Arizona

BY THE COMMISSION:

FINDINGS OF FACT

1. On November 8, 2002, Arizona Public Service Co. ("APS" or "Company") filed an application for a waiver of Arizona Administrative Code ("A.A.C.") R14-2-804(B)(1) and (2) (the "Rules"). Specifically, APS seeks to make short-term advances of funds to its parent, Pinnacle West Capital Corporation ("Pinnacle West"), or to make short-term guarantees of Pinnacle West's debt, as more fully described below.

2. The financing statutes would allow APS to execute this transaction without Commission approval but for Rule 804, one of the Commission's affiliated interests rules. Those rules state in relevant part:

> R14-2-804. Commission Review of Transactions Between Public Utilities and Affiliates
>
> B. A utility will not consummate the following transactions without prior approval by the Commission:
>
> 1. Obtain a financial interest in any affiliate not regulated by the Commission, or guarantee, or assume the liabilities of such affiliate;
>
> 2. Lend to any affiliate not regulated by the Commission, with the exception of short-term loans for a period less than 12 months in an amount less than $100,000...

and

R14-2-806. Waiver from the Provisions of this Article

A. The Commission may waive compliance with any of the provisions of this Article upon a finding that such waiver is in the public interest.

3. APS intends to loan Pinnacle West up to an aggregate principle amount of $125,000,000 for a period of up to 364 days ("Backup Line of Credit") or to guarantee Pinnacle West debt up to an aggregate principle amount of $125,000,000 ("Interim Guarantee") for the same period. APS wants to undertake these obligations because Pinnacle West recently lost the ability to renew a $125,000,000 364-day bank facility ("Bank Facility") that was used to support Pinnacle West's commercial paper program. The Bank Facility expires November 29, 2002. The commercial paper program funds Pinnacle West's ongoing operations. Commercial paper programs are normally backed by some form of credit, such as the expiring Bank Facility, and loss of such backup would normally result in loss of an ability to sell commercial paper in the same amount.

4. Staff confirmed that Pinnacle West is expected to suffer liquidity problems if it was unable to access its full commercial paper program, including the $125,000,000 commercial paper or similar program. Pinnacle West needs the credit facility or a similar cash source to manage its cash flows over the next year. Without access to these or similar sources, Pinnacle West's cash flow will likely become negative relatively soon.

5. The application states that the Backup Line of Credit or Interim Guarantee is necessary to stabilize the financial condition of Pinnacle West and its affiliates and to avoid rating downgrades. On November 4, 2002, Standard & Poor's Ratings Services ("S&P") lowered APS' corporate credit rating to BBB from BBB+. The downgrade was the result of S&P's consolidating the ratings of APS and Pinnacle West because of a lack of regulatory insulation between the two entities.

6. APS' application asserts that it will not be required to borrow funds to finance either the Backup Line of Credit or the Interim Guarantee and that neither would result in a loss of APS' overall credit quality or debt rating or in any manner adversely affect APS customers. The application further indicates that APS would avoid further deleterious financial consequences through Pinnacle West if the application was granted and APS was allowed to support its parent through the Backup Line of Credit or the Interim Guarantee.

7. APS asserts that "it is making this emergency request to address a deteriorating financial situation arising from the Arizona Corporation Commission's ("Commission") dramatic "reversal of course" on divestiture of generation assets by APS and the necessary integration of APS and Pinnacle West Energy Corporation ("PWEC") generation as called for under the 1999 APS Settlement Agreement and the Commission's Electric Competition Rules." Staff, however, established that the exigent circumstances are due to market conditions quite apart from any Arizona action. Those market conditions include a reduction in credit extended to the energy industry generally.

8. In Staff's assessment, the situation described by APS presents an exigent circumstance, especially when viewed in the context of the energy sector as a whole. Failing to address the liquidity problem at Pinnacle West could cause significant problems for APS. Because of this risk and because of the attendant turmoil currently surrounding the energy industry, prompt action by the Commission is appropriate. The limited size and duration of the request weighed against the potential harm that could accrue to APS indicates that the waiver is in the public interest. Finally, granting this application will preserve the status quo without prejudicing the Commission's ability to evaluate the pending APS financing application. Approval of this waiver application is not intended to prejudge the pending financing application in Docket No. E-10345A-02-0707

9. Staff further believes that the lack of regulatory insulation between APS and Pinnacle West has the potential to result in APS suffering further deleterious derivative financial consequences, such as rating downgrades, if Pinnacle West suffered liquidity problems. For these reasons, Staff recommends that the Commission examine methods for improving the regulatory insulation between APS and its affiliates in the pending financing application.

10. Staff recommends that APS be granted a waiver of Rule 804(B)(1) and, to the extent necessary, Rule 804(B)(2) subject to the following four conditions:

(a) The pricing schedule between Pinnacle West and APS for the Backup Line of Credit shall be the existing pricing schedule on the expiring Bank Facility at Level IV status (or Level V if Pinnacle West's ratings fall below either BBB- by S&P or Baa3 by Moody's). Other terms and conditions of the Backup Line of Credit shall be the same as the expiring Bank Facility.

(b) APS shall acquire a $125,000,000 security interest in certain Pinnacle West Energy Corp. assets.

(c) All revenues received by APS pursuant to this authority shall be deferred and accounted for in a manner to allow amortization as a credit to customers in the next rate case.

(d) The Commission shall examine methods for improving the regulatory insulation between APS and its affiliates in the pending financing application.

These conditions are designed to ensure that APS' ratepayers will be adequately protected from any potential risk associated with this transaction.

CONCLUSIONS OF LAW

1. Arizona Public Service Co. is an Arizona public service corporation within the meaning of Article XV, Section 2 of the Arizona Constitution.

2. The Commission has jurisdiction over Arizona Public Service Co., and over the subject matter of the application.

3. The Commission having reviewed the application and Staff's memorandum dated November 14, 2002, concludes that it is in the public interest to approve a waiver to A.A.C. R14-2-804(B)(1) and (2) under the terms and conditions described above, including conditions (a) through (d) articulated in Finding of Fact 10.

ORDER

IT IS THEREFORE ORDERED that Arizona Public Service Corp. be approved a waiver to A.A.C. R14-2-804(B)(1) and (2) under the terms and conditions described above, including conditions (a) through (d) articulated in Finding of Fact 10.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this ________ day of ________________, 2002.

____
BRIAN C. McNEIL
Executive Secretary

DISSENT: ________________________

EGJ:JST

SERVICE LIST FOR: Arizona Public Service Co.
DOCKET NO. E-01345A-02-0840

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