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Arizona Corporation Commission
DOCKETED

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October 11, 2002

Docket Control
Arizona Corporation Commission
1200 W. Washington
Phoenix, Arizona 85007

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RE: ARIZONA PUBLIC SERVICE COMPANY'S REQUEST IN THE MATTER OF THE APPLICATION FOR AN ORDER OR ORDERS AUTHORIZING IT TO ISSUE, INCUR, OR ASSUME EVIDENCES OF LONG-TERM INDEBTEDNESS; TO ACQUIRE A FINANCIAL INTEREST OR INTERESTS IN AN AFFILIATE OR AFFILIATES; TO LEND MONEY TO AN AFFILIATE OR AFFILIATES; AND TO GUARENTEE THE OBLIGATIONS OF AN AFFIIATE OR AFFILIATES PURSUANT TO ACC DOCKET NOS. E-01345A-02-0707.

Dear Sir or Madam:

Pursuant to the Procedural Order dated October 9, 2002, Docket No. E-01345A-02-0707, Arizona Public Service Company is hereby filing the direct testimony of Mr. Arthur H. Tildesley and Ms. Barbara M. Gomez.

If you or your staff have any questions, please feel free to call me.

Sincerely,

Jana Van Ness
Manager
Regulatory Compliance

Attachment

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DIRECT TESTIMONY OF ARTHUR H. TILDESLEY

Managing Director, Salomon Smith Barney Inc.

On Behalf of Arizona Public Service Company

Docket No. E-01345A-02-0707

October 11, 2002

DIRECT TESTIMONY OF ARTHUR H. TILDESLEY
ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY
(Docket No. E-01345A-02-0707)

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Arthur H. Tildesley. I am a Managing Director of Salomon Smith Barney Inc. ("SSB"). My business address is 388 Greenwich Street, New York, New York 10013.

Q. COULD YOU BRIEFLY DESCRIBE THE BUSINESS OF SSB AND INDICATE WHAT YOUR RESPONSIBILITIES ARE AS A MANAGING DIRECTOR OF SSB?

A. SSB is one of the world's leading securities firms with expertise in the full spectrum of capital raising and financial advisory services. SSB is a wholly-owned subsidiary of Citigroup – the world's largest financial institution with total assets of over \$1 trillion and a presence in over 100 countries worldwide.

I joined the Investment Banking Division of Salomon Brothers, one of the predecessor companies of SSB, in 1986. Currently, I am a Managing Director and Co-Head of SSB's North American Power Group. I have primary relationship responsibility with regard to a broad number of companies in the power sector, including Arizona Public Service ("APS") and its parent company, Pinnacle West Capital Corporation ("PWCC"). My experience includes over one hundred debt, preferred and equity financing transactions and numerous strategic advisory and merger and acquisition assignments involving top 25 utilities (ranked by size). Those assignments include advising PacifiCorp on the merger with Scottish Power, Florida Progress on its combination with Carolina Power and Light and most

recently, advising Western Resources on its proposed split-off of its unregulated businesses. My biography setting forth my qualifications is attached as Appendix A.

Q. WHAT IS THE RELATIONSHIP BETWEEN SSB AND APS?

A. SSB has a long-standing relationship with APS and its affiliates. Since 1990, SSB has participated in 26 public debt offerings for APS, including ten offerings in which SSB acted as a bookrunner and 16 offerings as a co-manager. The total amount of debt capital raised in these transactions aggregated to \$3,868 million. In addition, Citigroup, through its lending subsidiary, has a lending relationship with APS and PWCC. Citigroup has been a participant in APS' credit facilities for more than a decade. Citigroup currently participates in both APS and PWCC's existing credit facilities. I would also note that SSB currently has investment banking relationships with, and Citigroup is a lender to, many other utilities and merchant generating companies, including those with operations in the State of Arizona.

Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS PROCEEDING?

A. In light of the Arizona Corporation Commission's ("ACC") decision on August 27, 2002 reversing both its requirement that Arizona utilities divest their generation assets and its previously unqualified approval for the transfer of APS generation to PWEC, SSB was asked by APS to address the following questions:

1. Does Pinnacle West Energy Corporation ("PWEC") presently have access to the capital markets on a standalone or non-recourse basis?

2. Do we believe that PWCC is likely to experience a credit rating downgrade if no action is taken to refinance the debt incurred at PWCC to temporarily finance the construction of PWEC generation assets (“the Bridge Debt”) at an operating company level, either APS or PWEC?
3. Is a financing plan involving an intercompany loan or guarantee provided by APS to PWEC feasible in the current capital markets environment?
4. What is the impact on the credit quality of APS of the proposed intercompany loan or guarantee by APS to PWEC?

Q. CAN YOU DESCRIBE HOW YOU WENT ABOUT FORMULATING YOUR FINDINGS AND CONCLUSIONS?

A. Yes. First, we relied only on data available to us from public sources. SSB worked independently from the internal analyses being undertaken by APS and PWCC. Second, we did not attempt to evaluate PWEC’s ability to actually service a loan for \$500 million – we simply assessed whether in our opinion PWEC could obtain a \$500 million loan from non-affiliated sources without credit support from APS. In fact, for purposes of determining the impact on APS, we assumed no repayment capacity at PWEC. Third, we analyzed the feasibility of an alternative financing plan involving either an intercompany loan or a guarantee provided by APS to PWEC, allowing the Bridge Debt to be refinanced. We did not make a specific recommendation to APS as to the loan versus guarantee alternatives. That determination is better left until closer to the actual transaction date, when more is known as to the receptivity of the financial markets to both of these potential transactions. Fourth, and for largely the same reasons as my third point, SSB did not attempt to formulate an

opinion on the type of debt security that either APS or PWEC should employ, the maturity thereof, or any of the other specific terms and conditions of issuance. APS also has very considerable experience in these matters and can make these determinations in consultation with the underwriters of this debt when it comes time to put together an actual financing package.

Q. DOES PWEC HAVE ACCESS TO THE CAPITAL MARKETS ON A STANDALONE BASIS?

A. No. Under current market conditions, PWEC would be unable to raise significant debt financing on a standalone or non-recourse basis. The reversal of the initial plan to transfer APS generation assets to PWEC substantially altered the business and credit profile of PWEC. Without the transfer of the APS generation assets or the establishment of some form of power purchase agreement (“PPA”), the business profile and credit quality of PWEC would be viewed as very weak. PWEC would be a pure merchant generating company with a relatively small asset portfolio (less than 2,000 MW operating or nearing completion) of intermediate and peaking assets concentrated in the Arizona market. It is our view that such a portfolio is not debt financeable in any meaningful amount in today’s marketplace.

The financial markets are aware that forward power prices have declined significantly in the region over the past year and that there is a substantial amount of new generating capacity being added in Arizona. Investors are concerned about the potential for an overbuilt market in Arizona, the potential that power prices could remain soft in the state, and the implications for PWEC’s ability to service debt as a standalone entity without the APS generation.

The current difficulty in raising capital to finance merchant generation is highlighted by the dearth of pure merchant financing in either the bank or bond markets since the fourth quarter of 2001. Standard and Poor's has indicated that they, in fact, believe this challenging environment will persist:

"The overcapacity will eventually be worked down through demand growth or retirement of older, less-efficient generating units. However, in the short term, *neither of these trends will likely occur to the extent necessary to encourage investors to lend eagerly to this sector.*" S&P, Refinancing Risk in the U.S. Power Sector—The Preponderance of Mini-Perm Debt, September 6, 2002 (italics added for emphasis)

Q. DO YOU BELIEVE THAT PWCC IS LIKELY TO EXPERIENCE A CREDIT RATING DOWNGRADE IF NO ACTION IS TAKEN TO REFINANCE THE BRIDGE DEBT AT AN OPERATING COMPANY LEVEL?

A. The present inability of PWEC to fund on a standalone or non-recourse basis in the bank loan or public debt markets absent the APS generation may well have adverse credit consequences for the entire Pinnacle West family of companies. The construction program at PWEC was funded through borrowings at PWCC on an "interim" or "bridge" basis. The parent company was intended to serve as a temporary vehicle for funding in advance of a permanent refinancing at PWEC after the transfer of the generation assets from APS. This strategy was well recognized by the rating agencies and fixed-income investors.

“Additionally, approximately \$800 million to \$900 million of financing will be provided to PWEC for construction of the 2,700 megawatts of new natural gas capacity. Approximately, *\$300 million has already been raised by PNW, the parent*, in a recent bond offering (6.40% Senior Notes due 2006 rated Baa2) ...” Moody’s, April 18, 2001 (italics added for emphasis)

The debt issuance at the parent provided a flexible and cost-effective financing mechanism prior to the transfer of the APS assets. All debt instruments issued by the parent company had short maturities (less than five years) and prepayment options in contemplation of a refinancing at PWEC. Figure 1 provides a summary of the public debt raised at PWCC since March 2001:

Figure 1. Summary of PWCC Public Debt Issued Since March 2001
(as of October 8, 2002)

Issue Date	Maturity	Amt (\$MM)	Coupon	Prepayment Option
7/26/01	8/1/2003	\$250	LIBOR+98 bp	Callable at par on each payment date
2/05/02	2/9/2004	215	4.50%	Make-whole call at T+25
3/21/01	4/1/2006	300	6.40%	Make-whole call at T+30
Total		\$765		

Note: Table excludes privately placed note and bank debt.

Moody’s states that if the debt remains at PWCC, the current Baa2 rating could be lowered. In a report dated September 10, 2002, Moody’s comments that:

“The rating outlook [for PWCC] is stable and *assumes the Pinnacle bridge financing is refinanced at an operating*

subsidiary in the intermediate term. Failure to do so could have negative rating implications.” (italics added for emphasis)

Q. WHAT IS THE IMPACT OF AN INTERCOMPANY LOAN OR GUARANTEE TO PWEC ON THE CREDIT QUALITY OF APS?

A. SSB has reviewed APS' proposed alternative financing plan. The plan contemplates that APS would provide an intercompany loan or credit guarantee to PWEC until the time when PWEC would be positioned to obtain standalone financing on acceptable terms. PWCC will continue to have a significant equity investment in PWEC.

Under the plan, PWCC will pursue one or both of the two options. Each is explained below.

The first option contemplates APS extending a \$500 million intercompany loan to PWEC. PWEC will use the proceeds from the loan to pay a dividend to PWCC with the cash used to pay down debt at the parent company level. In order to fund the loan to PWEC, APS will issue \$500 million of public debt. Debt service obligations of APS will be met through the payments received from PWEC on the intercompany note. An intercompany borrowing by PWEC from APS provides an attractive solution from an execution point of view. It capitalizes on APS's strong market access and efficient borrowing cost, benefits from investors' familiarity with APS story and offers a simple and transparent structure easily understood by investors.

Under the second option, the \$500 million financing will be obtained by PWEC in the public bond or bank loan market. In order to make such

financing viable, APS will provide an intercompany guarantee for the notes issued by PWEC. The guarantee will cover periodic interest payments and repayment of principal. While this structure may be perceived by investors as somewhat more complex and may be marginally more expensive than an intercompany loan, it has the benefit of the notes being issued directly by PWEC.

Our analysis indicates that APS business fundamentals and credit statistics are strong, and we believe that APS has sufficient credit capacity to provide an intercompany loan or guarantee to PWEC in the amount of \$500 million without impairing fundamental utility credit quality. The table below summarizes credit statistics of APS as compared to the S&P credit statistics guidelines.

Figure 2. Credit Statistics for APS

Credit Ratio	Actual Credit Ratio	Credit Ratio Pro Forma for \$500 Million Intercompany Debt	Credit Ratio Pro Forma for \$500 Million Guarantee	S&P Benchmark for BBB Rating, Business Profile 3
FFO Interest Coverage	4.0x	3.6x	3.5x	2.1x - 3.1x
FFO / Total Debt	17.2%	14.9%	14.2%	14% -20%
Total Debt / Total Capitalizator	56.6%	60.6%	60.6%	53% - 61%
EBIT / Interest	4.5x	3.2x	3.2x	1.8x -2.8x

Source: APS public filings and Standard & Poor's.

Based on APS balance sheet data as of 6/30/2002 and the FFO and Interest for the 12 months ended 6/30/2002.

There may be an additional benefit of the alternative financing plan. The credit quality of a vertically integrated electric utility typically reflects the perceived supportiveness of regulation. Rating analysts and bondbuyers prefer predictability and stability, i.e. "no surprises." The alternative

financing plan would be viewed by market participants as a constructive regulatory action that would help offset to the uncertainty created by the reversal in the divestiture plan.

Q. ARE THE INTERCOMPANY LOAN AND GUARANTEE PROPOSALS FINANCEABLE IN CURRENT MARKET ENVIRONMENT?

A. Based on SSB's review of current public debt and bank loan market conditions, we believe that the proposed financing alternatives, involving either the intercompany loan or the guarantee, would be financeable in the public debt or bank loan market.

Q. WHAT DOES YOUR ANALYSIS CONCLUDE?

A. Based on our analysis, we have come to three basic conclusions:

1. If PWEC is not able to obtain new debt financing on a standalone or non-recourse basis, and therefore the PWCC Bridge Debt must be refinanced at the parent level as permanent parent debt, it is possible that the credit quality of PWCC will suffer.
2. PWEC does not have access to third-party debt financing on a non-recourse basis in any meaningful amount.
3. The alternative financing plans of either an intercompany loan or a guarantee from APS to PWEC provides a financeable and cost-effective transition plan for continuing

the funding of the PWEC generation. Our analysis confirms that APS has excess debt capacity sufficient to allow it to borrow approximately \$500 million without significant impact on the current credit quality of APS. We further expect that a supportive action by the ACC would be viewed positively by financial market participants as a constructive regulatory action that would help offset to the uncertainty created by the ACC's reversal of the divestiture plan.

Q. DOES THAT CONCLUDE YOUR WRITTEN DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, it does.

APPENDIX A

Biography of Arthur H. Tildesley, Jr.

Managing Director and Co-Head of the Global Power Group, New York. Mr. Tildesley joined Salomon Brothers in August 1986, served as a generalist in the Corporate Finance Department, completed a dedicated rotation on the Capital Markets Desk, and joined the Global Power Group in mid-1988.

Mr. Tildesley's experiences include over one-hundred debt and preferred financing transactions and numerous strategic advisory and merger and acquisition assignments involving top 25 utilities (ranked by size). Those assignments include advising PacifiCorp on the merger with Scottish Power, Florida Progress on its combination with Carolina Power and Light and most recently, advising Western Resources on its proposed split-off of its unregulated businesses.

Mr. Tildesley received a B.S. in Accounting from Widener University in 1982 and an M.B.A. from Harvard Business School in 1986. Prior to joining Salomon Brothers, he worked with Arthur Young & Co. in New York for two years.

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DIRECT TESTIMONY OF BARBARA M. GOMEZ

On Behalf of Arizona Public Service Company

Docket No. E-01345A-02-0707

October 11, 2002

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3 **DIRECT TESTIMONY OF BARBARA M. GOMEZ**
4 **ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY**
5 **(Docket No. E-01345A-02-0707)**

6 I. **INTRODUCTION**

7 **Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.**

8 A. My name is Barbara M. Gomez. My business address is 400 North Fifth Street,
9 Phoenix, Arizona, 85072. I am Treasurer for Arizona Public Service Company
10 (“APS” or “Company”). I am also Treasurer of Pinnacle West Capital
11 Corporation (“PWCC”) and Pinnacle West Energy Corporation (“PWEC”).

12 **Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL
13 BACKGROUND?**

14 A. My resume is attached as Appendix A to my testimony.

15 **Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS
16 FINANCING PROCEEDING?**

17 A. There are several. First, I will explain to the Commission the plan for permanent
18 financing of the new generation constructed or being constructed by PWEC that
19 was in effect prior to the entry of Decision No. 65154 (September 10, 2002).
20 Second, I discuss the significantly negative impact of Decision No. 65154 on
21 that permanent financing plan. Third, I will describe the Company’s proposal to
22 partially recover from this particular aspect of Decision No. 65154 through an
23 inter-company loan, a corporate guarantee, or a combination of both. Finally, I
24 analyze the impact of the Company’s financing proposals on APS. When taken
25 together, my testimony will establish that the APS proposals are, in the words of
26 A.R.S. § 40-301 (C): “for lawful purposes which are within the corporate

1 powers of the applicant [APS], are compatible with the public interest, with
2 sound financial practices, and with the proper performance by the applicant
3 [APS] of service as a public service corporation and will not impair its ability to
4 perform that service.”

5
6 **Q. WILL APS PRESENT ANOTHER WITNESS ON DIRECT IN THIS PROCEEDING?**

7 A. Yes. Mr. Arthur H. Tildesley, a Managing Director of Salomon Smith Barney
8 (“SSB”), was retained by the Company to examine generation financing options
9 in light of the Commission's Special Open Meeting on August 27, 2002, which
10 Meeting resulted in the issuance of Decision No. 65154. Mr. Tildesley
11 independently evaluated some of the same issues as I did, along with other
12 financial experts for the Company. His conclusions provide independent
13 confirmation of my own.

14
15 **II. SUMMARY**

16 **Q. WOULD YOU PLEASE SUMMARIZE YOUR DIRECT TESTIMONY?**

17 A. PWEC was the creation of the Commission’s Electric Competition Rules and
18 the 1999 APS Settlement Agreement (“1999 Settlement”). Without the promise
19 of receiving APS’ existing generation portfolio, PWEC would never have been
20 formed and could not be sustained as an investment-grade business fully capable
21 of competing over the long run with the much larger competitors in the
22 unregulated generation business such as Duke, PG&E, and Reliant, for example.
23 It certainly would not have foregone the opportunity to sell electricity forward
24 into the California market in 2000 and 2001. I personally helped negotiate
25 PWEC’s credit rating—a rating that was contingent upon receiving the APS
26 generation as promised by the 1999 Settlement.

1 Until the APS generation could be transferred to PWEC, it was necessary both
2 that PWEC undertake new generation construction to serve APS load growth
3 after 1999 and that such construction be financed in the interim. Because APS
4 was presumably going out of the generation business pursuant to the 1999
5 Settlement and the Electric Competition Rules, the logical candidate for
6 supporting this interim financing was PWCC. Again, I was personally involved
7 in that effort, which was only successful because PWCC could show the rating
8 agencies the Commission order approving the 1999 Settlement, thus assuring
9 them that this would only be an interim arrangement until divestiture could be
10 completed by year-end 2002.

11
12 Decision No. 65154 made implementation of the original financing plan
13 impossible. Not only was the investment-grade rating upon which PWEC's
14 plans had been premised now gone, other options such as project financing that
15 had previously been rejected as uneconomic became wholly unavailable to
16 PWEC. Attempting to permanently finance PWEC's Arizona generation through
17 PWCC risked almost certain credit downgrades by the credit rating agencies.
18 Such downgrades are expensive in the best of times, and these are among the
19 worst of times for financing electric generation. The financial community,
20 including ratings agencies, was aware of the many benefits conferred on APS
21 customers as a result of the 1999 Settlement, and were thus surprised that certain
22 of its other terms, most specifically divestiture, were not going to be honored by
23 the Commission. These agencies, as well as investment analysts, were looking
24 to the Company for a reasonable proposal that APS could present to this
25 Commission and to this Commission for action to begin rectifying the situation
26 caused by Decision No. 65154. The Recovery Plan is just such a proposal.

1 APS has significant unutilized financing capability. It would be both possible
2 and reasonable for APS to lend sufficient amounts to either PWEC or PWCC to
3 partially refinance the bridge financing provided to PWEC by PWCC.
4 Alternatively, a guarantee by APS of PWEC debt was likewise feasible. At the
5 same time, APS would itself benefit considerably from the “good will” that
6 would be created in the financial community by any solution that would address
7 at least partially the damage done by Decision No. 65154. Moreover, the
8 continued existence long-term of PWEC in Arizona as a strong and viable
9 competitor could contribute significantly to price discipline in the Arizona
10 wholesale electric market, another obvious benefit to APS and its customers. I
11 further insisted that APS be directly compensated by its affiliates for every dime
12 of cost incurred in this financing proposal, which I refer to as the “Recovery
13 Plan” in my testimony.

14
15 In addition, I also had to assure APS and PWCC management—most especially
16 myself—that each of these programs, or any combination thereof that went into
17 formulating the Recovery Plan, would not hurt the Company’s financial
18 condition even in the event of a complete PWEC or PWCC default. I therefore
19 proceeded to calculate the relevant financial and coverage ratios. I consulted
20 with experts within the Company and outside experts such as Mr. Tildesley. We
21 also spoke with our contacts in the investment community about the feasibility
22 of the Recovery Plan. Only after I was completely satisfied that these proposals
23 were safe for APS from a financial point of view did I support the filing of this
24 Application.

1 In conclusion, the APS Application is a fair and practical—if only partial—
2 solution to a serious problem that APS neither anticipated nor created. Indeed,
3 this Application would never have been necessary had the 1999 Settlement been
4 upheld as agreed to or had APS not been prohibited from constructing the
5 PWEC Arizona generation by the terms of its Commission-imposed Code of
6 Conduct.

7
8 Granting the relief requested still leaves APS, PWCC and PWEC worse off than
9 they were before Decision No. 65154. But there would at least be in place a
10 viable Recovery Plan for proceeding forward with the permanent financing of
11 PWEC's Arizona generation, one that would permit PWEC to continue as a
12 viable force for long-run price moderation in the Arizona competitive generation
13 market (itself a clear benefit to APS). It does so at what my analysis shows is
14 negligible risk to APS. In contrast, the risk of harm to APS from the
15 Commission's doing nothing is far from negligible and is likely to have both
16 short and long-term negative implications for APS and its customers.

17
18 **III. FINANCING OPTIONS PRIOR TO DECISION NO. 65154**

19 **Q. WHY WAS PWEC CREATED AND WHAT WERE THE ESSENTIAL**
20 **FINANCIAL ASSUMPTIONS THAT SUPPORTED BOTH ITS**
21 **CREATION AND SUBSEQUENT ACTIVITIES?**

22 **A.** I was not responsible for PWEC's creation, but as an officer of the Company, I
23 necessarily was aware of the requirement to divest APS generation under the
24 Electric Competition Rules. APS had opposed from the beginning a
25 Commission Staff proposal to require divestiture of the Company's generation
26 to out-of-state merchant entities. When the Electric Competition Rules were
modified to allow divestiture to an affiliate of APS, we began to take that

1 proposal seriously. APS realized, however, that any such APS affiliate would be
2 a relatively small player in the unregulated generation market when compared to
3 the generation affiliates of utilities such as PG&E, SDG&E, and Reliant, for
4 example, and also as compared to massive IPPs such as Calpine and Dynegy.
5 PWEC would have no national presence and little name recognition in the
6 financial markets except as an affiliate of a single-state regulated utility. If new
7 generation was to be constructed by PWEC on a competitive basis, it would
8 need to present the financial market with solid credit credentials of its own. The
9 Electric Competition Rules seemingly provided the basis for obtaining such
10 credit credentials, what with their required divestiture of APS generation—a
11 requirement that could be met by divestiture to an affiliate. This was reinforced
12 by the Commission's approval of the 1999 Settlement, which specifically
13 granted all approvals necessary for divestiture and further found that divestiture
14 was in the public interest. Although the Electric Competition Rules could be and
15 had been modified from time to time, the Commission had, to my knowledge,
16 never previously modified a settlement once such settlement had been approved.

17 **Q. WHAT HAPPENED NEXT?**

18 A. There was now a specific business plan that could be taken to Wall Street—a
19 plan premised on divestiture. By the Spring of 2001, PWEC had secured
20 investment grade ratings from all the major rating agencies contingent on asset
21 divestiture from APS. *See* Schedule BMG-1

22
23 **Q. DID THESE AGENCIES ALSO ANTICIPATE A TRANSITION PPA
24 BETWEEN PWEC AND APS?**

25 A. Yes. Transition buy-back arrangements were common in divestiture situations,
26 and APS would be transferring an impressive portfolio of diverse generation to

1 PWEC. Certainly I, and I would presume others, anticipated that the ACC would
2 wish APS to have continued access to that portfolio at established prices until
3 the wholesale competitive market in Arizona had proven itself reliable and
4 stable. In fact, the rating agencies assumed that there would first be a short
5 transition full-requirements PPA for 2001 and 2002 that would be phased-out in
6 2003 and 2004 as APS acquired more of its generation requirements from the
7 market, with the corresponding freeing-up of PWEC's newly acquired APS
8 generation to sell into that market. If, on the other hand, ratings agencies had
9 been assured that PWEC would be free to market the low cost power received
10 from the base-load APS assets to the highest bidder in the competitive market, it
11 may have appeared to them more advantageous to PWEC, given then projected
12 market prices, than did their alternative assumption of a short-duration PPA.

13 **Q. DID PWEC BEGIN CONSTRUCTION OF NEW GENERATION PRIOR**
14 **TO THE ANTICIPATED DATE OF DIVESTITURE UNDER TERMS**
15 **OF THE 1999 SETTLEMENT? IF YES, COULD YOU PLEASE**
16 **EXPLAIN WHY?**

17 **A.** Yes. APS forecasts showed a need for additional generation in the Valley.
18 Thus, work on West Phoenix CC-4 began in June of 2000. West Phoenix CC-5
19 was also planned as yet additional in-Valley generation, with construction
20 beginning in September of 2001. At this time, Western markets appeared quite
21 volatile, and the Company's system planners believed that the "build or buy"
22 decision strongly favored the build option. This was the genesis of Redhawk,
23 initially referred to in Company planning documents as "Hedgehog." Again,
24 APS could not engage in competitive electric service activities even prior to
25 year end 2002 under the terms of its Commission-imposed Code of Conduct, so
26 constructing these units at APS using APS credit, and then transferring them to
PWEC at the end of 2002, was not a practical option.

1 Q. **WHERE DID PWEC GET THE NECESSARY FINANCING FOR THIS**
2 **CONSTRUCTION?**

3 A. PWCC had an investment grade rating, and although lenders and ratings
4 agencies were not indifferent to the fact that none of the APS or PWEC
5 generation would be owned by PWCC, they understood that this would be only
6 a temporary situation. PWCC began borrowing funds in February of 2001 and
7 by July 1st of this year had incurred some \$635 million in bridge debt for PWEC
8 construction. By next summer, when all of PWEC's presently underway Arizona
9 construction will be complete, this will increase to approximately \$765 million,
10 including bank and privately-held debt. Virtually all this debt will mature by
11 February 2004, with the bulk of it in mid-2003.

12 Q. **DID YOU CONSIDER OTHER OPTIONS TO THE BRIDGE**
13 **FINANCING?**

14 A. As I discussed earlier, using APS financing was not necessary at that time given
15 the promised divestiture in the 1999 Settlement. Long-term financing at the
16 PWCC level also appeared unnecessary for the same reason, and I doubt it
17 would have been a practical solution. Such financing would have had to have
18 been fully assignable to PWEC once PWEC received the APS generation, a
19 right for which lenders would have demanded a premium. Also, the lack at
20 PWCC of tangible, revenue-producing generation assets would have been a
21 greater problem to lenders and ratings agencies if the debt had been for 10 to 20
22 years rather than one to three years. Project financing may have been available
23 to PWEC at that time, especially if PWEC had a firm contract in hand for the
24 sale of its output, but such financing would have been more expensive than
25 waiting until the end of 2002 and then using PWEC's investment grade rating to
26 secure non-project financing. Moreover, PWCC had already rejected the idea of

1 selling these plants' future output forward into the California market, believing
2 them necessary to serve APS customers. It would also have violated the
3 fundamental business premise upon which PWEC had embarked into
4 construction of unregulated generation—that it would receive the Company's
5 existing generation as promised under the 1999 APS Settlement and leverage
6 that portfolio into the credit quality PWEC would need to be fully competitive
7 over the long haul.

8
9 **IV. IMPACT OF DECISION NO. 65154**

10 **Q. HOW DID DECISION NO. 65154 IMPACT THE PREVIOUS
11 FINANCING PLAN YOU HAVE DISCUSSED?**

12 **A.** PWEC's investment grade rating and the possibility of obtaining one were
13 obviously gone. Without the APS assets, the present market prices for power
14 simply won't support an investment grade rating for new gas-fired generation
15 owners. Thus, even if PWEC were to win in the competitive procurement
16 process all or most of the APS load not met from retained APS generation, it
17 would not resolve the problem. Moreover, the credit market has become so tight
18 that project financing is pretty much unavailable at any price. Thus, rather than
19 having PWEC's contingent debt ratings be revised downward to non-investment
20 grade status, which may have impacted its future financing potential, or
21 continuing to pay these agencies for what was now an essentially worthless
22 rating, I was forced to ask these agencies to simply withdraw their previous
23 ratings of PWEC.

24 **Q. WHY NOT JUST KEEP ROLLING THE DEBT OVER AT PWCC?**

25 **A.** As I discussed previously, the ratings agencies and the lenders were never
26 particularly comfortable over the separation of the assets from the debt, even

1 during the better market conditions of 2001 and early 2002. With the greater
2 scrutiny being shown to all credit parameters in the energy industry, and most
3 especially in the unregulated part of the energy industry, PWCC can not
4 continue to carry this much debt without a high risk of downgrading. Even
5 before the additional Bridge Debt that PWCC will incur between now and next
6 summer, the amount of debt at PWCC was well above that which would support
7 its present credit rating. The relationship between overall consolidated enterprise
8 leverage and the debt held at the holding company level is discussed in several
9 articles published by Moody's Investors Service. In *Notching for Differences in*
10 *Priority of Claims and Integration of the Preferred Stock Rating Scale*, Moody's
11 Investors Service (November 2000), Moody's states:

12 Holding company debt is generally structurally subordinate
13 to all debt and preferred stock of the principal operating
14 company. Holding company debt will generally be rated at
or below the lowest rated instrument of the principal
operating company.

15 In another article published that same year, Moody's added:

16 Not only is the amount of debt important, but also its location
17 within the corporate structure. Most of the increase in debt
18 has been at the parent level. . . . The increase in debt at the
19 parent is reflected in ratings in two ways. First, the spread
20 between the parent rating and the operating company
21 unsecured rating has widened in many cases beyond the one
notch described above, and may widen for others going
forward. Second, since the utility or operating company
dividends are so critical to parent debt service, impairment of
the operating companies' financial flexibility will likely be
reflected in its own rating.

22 *Creeping Leverage: Growth in Electric Holding Company Debt*, Moody's
23 Investors Service (April 2000). PWCC itself also has no way of collateralizing
24 these loans or otherwise generating any additional credit support by its own
25 means within the relevant time period of between now and next summer. I
26 believe Mr. Tildesley's independent analysis, although relying on somewhat

1 different and independently obtained market data, strongly supports my
2 conclusions and concerns.

3
4 **Q. WHAT WOULD BE THE IMPACT OF SUCH A DOWNGRADE IN
PWCC CREDIT?**

5 A. Focusing just on PWCC, that would first depend on how much of a downgrade
6 PWCC experienced. If only a single notch, PWCC would fall to the lowest
7 investment grade rating. Although the spread between middle and low
8 BBB-rated energy companies fluctuates over time, our analysis of interest rates
9 using current Bloomberg shows that the spread is approximately 150 basis
10 points. If PWCC slips two notches, the cost could be much higher—perhaps as
11 much as 300 basis points. *See* Schedule BMG-2. This higher interest cost
12 translates into between \$1.5 million and \$3 million per year per \$100 million of
13 debt. I would also add that a two-notch drop in PWCC's long-term debt rating
14 would reduce it to non-investment grade, which restricts access to public credit
15 markets on any terms, especially under today's circumstances. And PWCC
16 would also lose access to the commercial paper market resulting in yet
17 additional financing costs. This is because even a low BBB rating on long-term
18 debt will not support a P-2 (Moody's) or A-2 (Standard & Poor's) commercial
19 paper rating, the lowest rating that has any current market acceptance.

20
21 The above analysis focuses solely on financing costs. A down-rating of PWCC
22 debt would also lead to higher operating costs. As a lesser-rated entity, the
23 marketing and trading division of PWCC would be foreclosed from some
24 transactions and subject to higher collateral and other credit support
25 requirements as to other transactions. We have not estimated the total operating
26 impact of a downgrade to PWCC credit, but it could be substantial.

1 **Q. COULD THERE BE NEGATIVE IMPACTS TO APS?**

2 A. Yes. Aside from the long-term impact on PWEC's competitiveness and
3 therefore its ability to contribute to market discipline, which I discuss later,
4 some ratings agencies such as Standard & Poor's ("S&P") already look to the
5 entire enterprise when establishing credit ratings for individual companies
6 within that enterprise such as APS. Even those who purport to analyze affiliates
7 on a stand-alone basis, such as Moody's, are not immune to this total enterprise
8 approach. For example, Moody's recently downgraded AES because of its
9 exposure to realized and potential trading losses. But Moody's also downgraded
10 AES' three operating utility subsidiaries (West Penn Power, Potomac Edison
11 and Monongahela Power) to non-investment grade status. Thus, any decline in
12 PWCC creditworthiness would be reflected in S&P's evaluation of APS. Just as
13 important, ratings agencies are expecting this Commission to do something to
14 rectify the problem created by Decision No. 65154. The very day that Decision
15 No. 65154 was issued, Moody's issued a report indicating that they assumed that
16 the PWCC bridge financing would be "refinanced at an operating subsidiary in
17 the intermediate term." And by "operating subsidiary," I can assure you they
18 were talking about APS and not APS Energy Services or SunCor Development.
19 Other rating agencies have made similar unsolicited statements to me. If such
20 positive Commission action is forthcoming, I believe it would be a very
21 significant plus for both APS and PWCC. On the other hand, Commission
22 failure to take steps to solve this problem when it could do so with minimal
23 impact on APS would likely be very negatively received. And lenders and
24 rating agencies do not usually suffer the receipt of negative news in silence.
25 They would extract a penalty from the Company and PWCC in the form of
26 higher capital costs. Therefore, the proposed Recovery Plan, which is

1 specifically addressed in the next section of my testimony, is very much
2 compatible with the Company's provision of service as a public service
3 corporation in this state.

4
5 V. THE RECOVERY PLAN

6 Q. **GIVEN THE PRESENT MARKET AND THE FINANCIAL**
7 **CIRCUMSTANCES OF APS AND ITS AFFILIATES, PWCC AND**
8 **PWEC, WHAT PLAN HAS APS PROPOSED TO ADDRESS THIS**
9 **FINANCING PROBLEM?**

10 A. APS has come up with two alternatives, the Recapitalization Debt and the
11 corporate guarantee of PWEC debt. Each of these alternatives meets the
12 following criteria: (1) they address the problem; (2) they do not harm and indeed
13 benefit APS; and (3) they do not further injure PWCC shareholders

14 Under the Recapitalization Debt proposal, APS would borrow funds in the
15 public capital market and lend them to PWEC. PWEC would pass these
16 proceeds to PWCC to pay off a significant portion of the Bridge Debt. PWEC
17 would issue a note to APS securing the repayment by PWEC to APS of all
18 financing costs, including repayment of all principal and interest on the APS
19 financing. The new APS debt would not be secured by APS assets (contrary to
20 certain news accounts) unless secured debt was all APS could reasonably issue
21 at the time. In that extremely unlikely circumstance, APS would then require
22 that the PWEC repayment note also be secured by PWEC's property. The
23 Company is also proposing that the new debt not be counted against the current
24 debt ceiling established for APS in Decision No. 55017 (May 6, 1986) for the
25 reasons set forth in the Application and which I will explain in more detail later
26 in my testimony.

1 Alternatively, APS could guarantee PWEC's issuance of its own debt. PWEC
2 would then flow the proceeds up to PWCC as with the loan scenario. APS's
3 guarantee would be limited to PWEC debt having a weighted average life of no
4 more than 10 years. In general this reflects the shorter debt maturity likely
5 available to non-regulated entities such as PWEC even though the debt would be
6 guaranteed. However, using a weighted average life of 10 years leaves open the
7 possibility of obtaining at least some lease financing for PWEC, which would
8 bring with it a maturity longer than 10 years. Under our proposal, any APS
9 guarantees longer than 10 years would have to be offset dollar for dollar by
10 guarantees of shorter duration. And because PWEC would be in a position to
11 potentially collateralize this PWEC debt with its own assets (in addition to its
12 having the Company's guarantee), this may produce lower overall financing
13 costs than under the loan scenario. However, this positive aspect of the
14 guarantee might be offset by the additional complexity of such a transaction and
15 the market's relative unfamiliarity with PWEC.

16
17 Under either the direct loan or the corporate guarantee proposals, the remaining
18 capitalization of PWEC would still be from PWCC. This would permit PWEC
19 to remain approximately 50% equity financed, which is consistent with its long-
20 term permanent financing objectives and with the original financing plan
21 presented to the rating agencies back in early 2001.

22 **Q. WHAT ARE THE RELATIVE ADVANTAGES OF EACH PROPOSAL?**

23 A. The inter-company loan is simpler and doesn't require the market to analyze
24 either a new set of documents (such as the form of guarantee) or a new entity
25 (PWEC). APS routinely issues unsecured debt for many purposes, and thus the
26

1 market is quite familiar with APS and with the type of debt instruments and loan
2 documents it uses. Simplicity and familiarity generally translate into lower costs,
3 and this is especially true today. The interest expense on the new APS debt and
4 the interest income to APS from the repayment note would be a wash on the
5 income statement. APS will have to reflect this additional debt on its balance
6 sheet. Although offset by an asset in the form of the repayment note from
7 PWEC, overall financial leverage would be increased at APS even though
8 consolidated debt levels would remain unaffected.

9
10 The guarantee's relative complexity and novelty may command what is referred
11 to as a structuring premium, i.e., additional cost largely attributable to the
12 structure of the deal itself rather than to deal fundamentals such as maturity date,
13 collateral, and creditworthiness. On the other hand, it does allow PWEC to get
14 its feet wet in the credit markets. This "financial discovery" by the market may
15 accelerate the day when PWEC can finance totally on its own. And although
16 APS would fully disclose the existence and terms of its corporate guarantees,
17 they would not impact the APS balance sheet because APS is not the primary
18 obligor on the debt. As under the direct loan proposal, a guarantee does not
19 affect the income statement unless it is both called upon and there is no
20 provision for reimbursement from PWEC. However, the Application specifically
21 indicates that PWEC will have to execute a standard reimbursement agreement
22 as a precondition of any APS guarantee.

23
24 **Q. WHY DOES THE APPLICATION REQUEST AUTHORITY TO DO
BOTH A DIRECT LOAN AND A GUARANTEE?**

25 **A.** The financial markets are in flux right now. Even if the guarantee option proves
26 more economical, the market may not support \$500 million of PWEC debt. APS

1 wishes to maintain maximum flexibility to pick either or both of these options so
2 long as the total principal amount of debt either issued by APS or guaranteed by
3 APS does not exceed \$500 million.

4
5 **Q. WHY DOES THE APPLICATION REQUEST AUTHORITY TO LOAN
6 MONEY TO BOTH PWEC AND PWCC?**

7 A. The Company's goal throughout this process is to resolve the financing problem
8 at the lowest overall cost to all involved, even though APS will not bear the
9 economic burden of such cost. Although the present plan is for APS to deal
10 with PWEC, it may prove more cost-effective and practical to direct the loan
11 proceeds or corporate guarantee directly to PWCC without using PWEC as
12 intermediary. Having the flexibility to do both or some combination of the two
13 is important to the achievement of this over-riding goal of cost minimization.

14 **Q. IN PARAGRAPH 15 OF THE APPLICATION, APS HAS ASKED THE
15 COMMISSION FOR SOME DISCRETION IN EFFECTUATING BOTH
16 THE RECAPITALIZATION DEBT AND THE APS CORPORATE
17 GUARANTEES. WHY IS SUCH FLEXIBILITY IMPORTANT?**

18 A. First of all, we are asking to be permitted no greater discretion than the
19 Commission granted the Company in both Decision Nos. 55017 and 54230
20 (November 8, 1984), which were the last two major APS financing proceedings.
21 Second, I believe the Company has earned the Commission's confidence that
22 this discretion will be appropriately exercised by its behavior in this regard over
23 the past 17 years. As is noted in the Application, APS has to date issued over \$5
24 billion in long-term debt pursuant to the authority granted in the two cited
25 Commission Decisions since 1985. There has never been a single issue raised,
26 major or minor, by Staff in or outside a rate proceeding concerning the propriety
of the Company's actions in executing the broad financing authority granted
APS by the Commission. And the results have been dramatic—a nearly 500

1 basis point drop in long-term embedded debt costs from 10.7% to less than 6%.
2 In today's crazy financial markets, the need for flexibility as to specific terms,
3 forms of collateral or other credit support, etc., is greater than ever before, and I
4 strongly urge the Commission to grant the Company this same degree of
5 properly administered discretion on these points as has been allowed by these
6 prior Commission Decisions.

7
8 **Q. WHY IS APS REQUESTING IN PARAGRAPHS 8 THROUGH 13 OF**
9 **THE APPLICATION THAT THE RECAPITALIZATION DEBT NOT**
10 **COUNT AGAINST THE LONG-TERM DEBT LIMIT ESTABLISHED IN**
11 **DECISION NO. 55017?**

12 A. If the guarantee option is utilized, there may be no new debt to count against the
13 cap, and thus the issue would be moot unless the Commission finds that a
14 guarantee in and of itself, although only a secondary and contingent liability,
15 constitutes an "evidence of indebtedness" within the meaning of A.R.S. § 40-
16 301, *et seq.* But whether or not APS actually issues the Recapitalization Debt or
17 a corporate guarantee or some combination of the two, the Company views this
18 as a one time "in and out" transaction and not part of its permanent utility
19 financing program. Consequently, it does not wish this specific transaction or
20 group of transactions, which are only intended to partially "right the ship" that is
21 in danger of foundering as a result of Decision No. 65154, to affect that
22 permanent utility financing program or in any way limit the flexibility of that
23 program. To accomplish this requires that APS maintain the present amount of
24 "headroom" or margin under the long-term debt financing limits established by
25 Decision No. 55017. The present margin is just under \$500 million. This margin
26 not only fluctuates as permanent debt is either issued or retired, but also in the
shorter term as the Company, at times, takes advantage of pre-financing
opportunities. In such instances, new debt is issued to lock in the interest rate on

1 a loan when most favorable to the Company but redemption or maturity of the
2 debt to be refinanced by this new debt does not actually occur until a later date.

3 **Q. BY WHAT CORPORATE AUTHORITY DOES THE COMPANY**
4 **PROPOSE TO ISSUE THE RECAPITALIZATION DEBT AND/OR**
5 **ISSUE ITS CORPORATE GUARANTEES?**

6 A. Article Second of APS's Articles of Incorporation allows APS to transact any
7 lawful business for which corporations may be incorporated under Arizona law.
8 Under A.R.S. § 10-302, a corporation may do all things necessary or convenient
9 to carry out its business and affairs, including borrowing or lending money,
10 pledging all or any part of its property, and issuing guarantees. Therefore, the
11 Company's issuance of the Recapitalization Debt, its issuance of corporate
12 guarantees, or any combination of the two, are within its corporate powers. Also
13 consistent with Arizona law and the Company's Bylaws, the APS Board of
14 Directors must approve any issuance of this debt or any corporate guarantees. A
15 meeting of the APS Board to consider such approval will be scheduled for
16 December of this year.

17 **Q. WILL ANY OF THE PROCEEDS FROM THE RECAPITALIZATION**
18 **DEBT OR THE APS CORPORATE GUARANTEES BE USED FOR**
19 **OPERATING EXPENSES OF THE COMPANY OR OTHERWISE**
20 **CHARGEABLE AGAINST ITS INCOME?**

21 A. Virtually all of the proceeds will be reflected on the Company's balance sheet as
22 additional debt or won't appear in either its balance sheet or income statement
23 (in the guarantee scenario). However, there are likely to be some relatively
24 minor issuance-related costs that are required to be expensed under present
25 accounting guidelines. Because A.R.S. § 40-302 (A) specifically requires
26 Commission authorization for such use of any proceeds, which the Commission

1 has in fact authorized in prior APS proceedings, the Company included a request
2 for this authorization in its Application.

3
4 **Q. IS WHAT YOU HAVE DESCRIBED AS THE RECOVERY PLAN THE ONLY ACTIONS PWCC AND PWEC ARE ENTERTAINING IN RESPONSE TO THEIR PRESENT CIRCUMSTANCES?**

5
6 A. No. The Recovery Plan we have proposed to the Commission is an important
7 element—in fact, the most important element—of our strategy to address the
8 fallout from Decision No. 65154. But it is far from the only element. Indeed, the
9 Company and its affiliates have been working on some aspects of a recovery
10 strategy since the Commission first indicated that it might be reconsidering
11 divestiture back in the late winter of 2001 and early spring of 2002.

12 **Q. WHAT ARE SOME OF THESE OTHER ACTIONS TO WHICH YOU JUST REFERRED?**

13 A. PWCC has existing cash flows from its operations unrelated to PWEC's
14 financing and also the normal dividend payments from its operating subsidiaries.
15 PWCC is actively exploring ways to accelerate and increase the dividend and
16 other cash flows from its non-APS subsidiaries. PWEC has already partnered
17 with the Southern Nevada Water Authority to finance 25% of the Silverhawk
18 project in Nevada. PWCC and PWEC have also taken steps to reduce operating
19 costs. Taken together with the Recovery Plan, the goal is to reduce total PWCC
20 debt (which is considerably above the Bridge Debt, which is itself considerably
21 above the \$500 million in financing authority sought in the Application) to
22 approximately \$400 million by 2005.

23
24 **Q. IN THE APPLICATION, APS REQUESTS A DETERMINATION ON THIS MATTER BY THE END OF 2002. WHY THE URGENCY IF THE CRISIS DOES NOT ARRIVE UNTIL NEXT SUMMER?**

25
26

1 A. Does the crisis begin when you fall out of a building or when you hit the
2 ground? The financial markets are changing for the worse every day, and there
3 is no guarantee that the proposed Recovery Plan could be effectuated next
4 Spring. Second, the very act of delay will be negatively perceived by the market,
5 which then might not wait until we've "hit the ground" before taking negative
6 action. Third, the guarantee proposal is somewhat novel and may take additional
7 time to both prepare the structure of the transaction and to educate the market to
8 properly receive this particular financing vehicle. Fourth, the Commission itself
9 during the August 27th Special Open Meeting appeared to recognize the need for
10 expeditious action to address the fallout from its decision to halt divestiture of
11 APS generation to PWEC.

12 **Q. IS EVEN THE FEAR OF THIS PROCEEDING BEING DELAYED**
13 **ALREADY HAVING AN ADVERSE IMPACT?**

14 A. Absolutely. Several banks are presently balking at any financing, even those
15 wholly unrelated to the Bridge Debt, having to do with PWCC until this matter
16 is resolved. As discussed above, this can only have a negative impact on APS as
17 well. I say this to highlight the need for resolute and prompt action on the
18 Company's Application.

19
20 The only alternatives to the Recovery Plan are punitive to PWCC shareholders
21 and/or impact the operations of PWCC and its affiliates. These include forced
22 sales of assets, further cutbacks on expenditures and capital outlays, and even
23 the potential for additional dilution of existing equity and potentially total
24 market capitalization from issuing new PWCC equity.

25
26

1 VI. IMPACT OF PROPOSED RECOVERY PLAN ON APS

2 **Q. YOU HAVE PREVIOUSLY TESTIFIED AS TO THE NEGATIVE**
3 **IMPACT ON APS SHOULD THE PRESENT FINANCING ISSUE NOT**
4 **BE RESOLVED ON TERMS THAT ARE FAIR TO PWEC AND PWCC.**
5 **WILL THE PROPOSED RECOVERY PLAN ITSELF ADVERSELY**
6 **AFFECT APS?**

7 A. Obviously, the course of action that would have had the least impact on APS
8 would have been to follow through with the 1999 Settlement and to have
9 granted the Company a hearing on its October 2001 request in Docket No. E-
10 01345A-01-0822. These now appear to be dead issues, however. But before
11 proposing the Recovery Plan set forth in our Application, we carefully analyzed
12 the potential and likely impacts of the two options (loan and guarantee) on APS.
13 See Exhibit F to the Application, a portion of which I have recreated here as
14 Schedule BMG-3. In addition, the Company asked Mr. Tildesley and SSB to
15 conduct their own analysis, which we have also presented to the Commission.
16 Both of us concluded that APS had significant additional debt capacity under
17 present market conditions, and that even under a "worst case" scenario, APS
18 would retain credit quality indicators consistent with its present ratings.

19 **Q. WHY DO YOU CALL THIS A "WORST CASE" SCENARIO?**

20 A. I have assumed no payments by PWEC or PWCC on the Repayment Note such
21 that none of the principal amount of the Recapitalization Debt is subsequently
22 repaid by PWEC and thus remains on the Company's balance sheet. Similarly,
23 none of the interest expense of such Recapitalization Debt is shown as offset by
24 interest income from the Repayment Note. In the case of the corporate
25 guarantee, I assume that the rating agencies will completely ignore the primary
26 liability of PWEC or PWCC for the guaranteed debt, as well as the existence of
the reimbursement agreement from PWEC/PWCC to APS, and will attribute

1 100% of the debt and interest to APS. This would mean that the analysis set
2 forth in Schedule BMG-3, Column (C) would also apply to the guarantee option.
3 But although ratings analysts tend to reflect "worst case" scenarios in their
4 calculations of the numbers, especially these days, I believe that they will at
5 least subjectively give some positive weight to the Company's efforts to protect
6 its own credit even under these most difficult of post-Decision No. 65154
7 circumstances.

8
9 **Q. ARE YOU SAYING THAT YOU CAN GUARANTEE THAT APS WILL
NOT BE DOWNGRADED?**

10 A. No. I can't guarantee that the Company won't be downgraded tomorrow, next
11 week, next month, or next year. But I am saying that I both believe such a
12 downgrading will not occur and that the credit indicators of the Company would
13 not support such a downgrading. I am further saying that the overall reaction of
14 the market to favorable and prompt Commission action on the APS Application
15 would be positive. And I am also saying that rejection of the Application by the
16 Commission would be received negatively in the financial community.

17
18 I would also add that as the Company's Treasurer, I would never proceed with a
19 debt issuance by APS without a good idea of how that issuance would be rated
20 and received by the investment community. If it appears that we can't issue the
21 entire \$500 million without harm to APS credit, even in the short run, I would
22 take that most seriously and would at such time again weigh the various
23 alternatives then available to the Company and its affiliates PWCC and PWEC.

24
25 **Q. ARE THERE OTHER ADVANTAGES TO APS FROM THE
COMMISSION'S GRANTING OF THE APPLICATION?**

1 A. Yes. The Commission is requiring APS to increase its dependence on the
2 competitive wholesale market as a result of its actual determination in Track A
3 of the Generic Docket (Decision No. 65154) and its likely determination in
4 Track B of that same Docket. A viable PWEC can contribute to that competitive
5 wholesale market. This will not be significant in the immediate term, but it is
6 likely very important to APS and its customers over the long run. Indeed, I am
7 told that Staff expressed an expectation during one of the Track B workshops
8 that PWEC would exercise some price discipline over that market in a manner
9 favorable to APS customers. I certainly hope that expectation is fulfilled, but a
10 prerequisite would be a reasonably healthy PWEC—one of the objectives of the
11 Recovery Plan.

12 **Q. WILL APS CUSTOMERS BE AFFECTED BY THE RECOVERY PLAN?**

13 A. The income effect on APS will be zero. Thus, again contrary to news accounts,
14 there will be no increased expense for APS to seek recovery of in future rate
15 proceedings. Similarly, the impact on APS' capital structure and resultant cost
16 of capital (if any) will be removed from the upcoming rate filing by means of a
17 pro forma adjustment.

18
19 And I hasten to add that APS consumers have already benefited greatly from the
20 1999 Settlement, the breach of which is what the Recovery Plan is designed to
21 partially mitigate. The most obvious of these benefits have been rate decreases
22 in 1999, 2000, 2001 and 2002. Perhaps less obvious but also perhaps more
23 important, is the reliability impact of having PWEC's generation up and
24 available to serve our peak demands in 2001 and 2002.

25
26

1 VII. CONCLUSION

2 **Q. DO YOU HAVE ANY CONCLUDING REMARKS?**

3 A. Yes. APS believes the Commission should not have abrogated its promise of
4 divestiture under the 1999 Settlement. It was especially inappropriate to do so
5 without a fair consideration of alternatives that could have addressed the
6 Commission's stated concerns with divestiture but at the same time either
7 allowed divestiture to go forward or, at the very least, mitigate the damage
8 attributable to the Company's justified reliance on the terms of the 1999
9 Settlement. That, however, is an argument for another day. In this proceeding,
10 the Company is proposing a Recovery Plan that can solve the financing problem
11 without foregoing other Commission options in the future, including the
12 eventual acquisition of all or a portion of PWEC's generation by APS for use in
13 providing service to the public. It does so at minimal risk to APS—certainly at
14 less risk than the alternative of doing nothing to solve a problem the
15 Commission largely created in the first instance.

16
17 But to be effective, approval of the Recovery Plan must be timely and allow the
18 Company the flexibility to implement it in the most cost effective manner
19 feasible. The present financial markets are unstable and incredibly cautious.
20 What they and APS need is positive action by the close of this year so that APS
21 will be in a position to implement the Recovery Plan when market conditions
22 are best and not at the last minute when the Company's leverage with lenders is
23 at its lowest ebb.

24 **Q. DOES THAT CONCLUDE YOUR PREFILED DIRECT TESTIMONY IN**
25 **THIS PROCEEDING?**

26 A. Yes, it does.

APPENDIX A

STATEMENT OF WITNESS QUALIFICATIONS

Barbara M. Gomez is Treasurer for Pinnacle West Capital Corporation ("PWCC") and for Arizona Public Service Company ("APS"). As Treasurer, Ms. Gomez has responsibility for long and short-term debt issuance and liability management, rating agency and banking relationships, daily cash management and trust investments.

Ms. Gomez graduated from Bucknell University in 1977 with a Bachelor of Science Degree in Business Administration and received an MBA, with an emphasis in Finance, from Arizona State University in 1982.

Ms. Gomez joined APS in 1978 and has held supervisory and managerial positions in various financial areas. From 1978 to 1987 her positions included financial analyst in the regulatory, budgeting, long-range planning and forecasting areas. She became a leader in 1987 and has managed the Planning and Treasury Operations departments, each on two separate occasions. In August of 1999, Ms. Gomez was promoted to Treasurer of PWCC and in October of 1999, Treasurer of APS. Ms. Gomez is a member of the Board of the National Association of Corporate Treasurers.

BMG-1

PWEC

Contingent Credit Ratings

**Moody's
S & P
Fitch**

**Baa2
BBB
BBB+**

BMG-2

Spreads above BBB2-rated Debt

BBB3	1.55%
BB	2.80%

Source: Bloomberg, 9/11/02

BMG-3

Financial Impact of Recapitalization Debt in (\$000)

<u>CURRENT APS</u>		<u>WITH RECAPITALIZATION DEBT</u>	
Current APS Debt	\$2,206,780	Additional Debt	\$500,000
Weighted Cost of Debt	5.93%	Additional Interest @ 5.5%	\$27,500
Annualized Long-Term Interest	\$130,862	Additional Interest @ 6.0%	30,000
		Additional Interest @ 6.5%	32,500

Financial Indicators

	(A) Per Books <u>June 2002</u>	(B) Proforma (1) <u>+ \$500M @ 6%</u>	(C) Rating Agency Approach <u>+ \$500M @ 6%</u>	(D) S&P "BBB" Targets (2) <u>Business Position 5</u>
<u>DEBT RATIO</u>				
Adj. Total Debt / Total Capital	54.4%	58.7%	58.7%	47% - 55%
<u>COVERAGE RATIOS</u>				
Pretax Interest Coverage	3.80	3.80	3.10	2.40 - 3.50
Adj. Pre-Interest FFO Interest C	4.53	4.53	3.92	3.00 - 4.00
Adj. FFO / Avg. Total Debt	23%	21%	21%	21% - 27%

Notes:

(1) Assumes interest income and interest expense on the \$500M is netted at APS

(2) Standard and Poor's last evaluation of APS as having a Business Position 3 was based on divestiture of generation assets that resulted in APS being a fully regulated transmission and distribution company.