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January 27, 2003

Colleen Ryan, Supervisor  
Document Control  
Arizona Corporation Commission  
1200 W. Washington  
Phoenix, AZ 85007

Re: Docket No. E-01345A-02-0707  
In the matter of the Arizona Public Service Company's Financing Application

Dear Ms. Ryan:

Enclosed for filing in the above-captioned proceeding are the original and nineteen (19) copies of the Sempra Energy Resources and Southwestern Power Group, II Initial Brief on APS's Financing Application, which is the subject of the above-referenced proceeding. Also enclosed are two additional copies to be conformed and returned to our office.

Please let me know if you have any questions, and thank you for your assistance.

Sincerely,

*Lawrence V. Robertson, Jr.*

Lawrence V. Robertson, Jr.

enclosures

BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER  
CHAIRMAN

JIM IRVIN  
COMMISSIONER  
WILLIAM A. MUNDELL  
COMMISSIONER

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JEFF HATCH-MILLER  
COMMISSIONER

MIKE GLEASON  
COMMISSIONER

IN THE MATTER OF THE APPLICATION )  
OF ARIZONA PUBLIC SERVICE COMPANY ) DOCKET NO. E-01345A-02-0707  
FOR AN ORDER OR ORDERS )  
AUTHORIZING IT TO ISSUE, INCUR, OR )  
ASSUME EVIDENCES OF LONG-TERM )  
INDEBTEDNESS; TO ACQUIRE A ) INITIAL BRIEF  
FINANCIAL INTEREST OR INTERESTS IN )  
AN AFFILIATE OR AFFILIATES; TO LEND )  
MONEY TO AN AFFILIATE OR )  
AFFILIATES; AND TO GUARANTEE THE )  
OBLIGATIONS OF AN AFFILIATE OR )  
AFFILIATES )

Pursuant to the schedule established by the Chief Administrative Law Judge, Sempra Energy Resources and Southwestern Power Group II, L.L.C ("Sempra/SWPG") hereby submit their Initial Brief in the above-captioned proceeding.

I.

INTRODUCTION

To the best of Sempra/SWPG's knowledge, the authorizations requested in Arizona Public Service Company's ("APS") September 16, 2002 Application present a case of first impression for the Commission.<sup>1</sup> As the following excerpts from its Application attest, APS is proposing to use its financial strength and creditworthiness to provide financial support to its unregulated generation

<sup>1</sup> ACC Staff witness Thornton also was unaware of any previous situation in which the Commission has had occasion to consider financing authorization requests of the nature and for the purposes of those now pending before the Commission in this proceeding. [Tr. 908, line 16- Tr. 909, line 14]

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1 affiliate, Pinnacle West Energy Corporation ("PWEC"), so that PWEC may more effectively  
2 compete in the competitive wholesale electric market which is the subject of the Commission's  
3 Track "B" proceedings in Docket No. E-00000A-02-0051.  
4

5 In support of its proposal, APS represents

6 " . . . PWEC is simply not sufficiently creditworthy under present  
7 market conditions absent credit support from APS." [Application at  
8 page 4, lines 20-21]

9 To rectify the aforementioned situation,

10 " . . . APS proposes to provide for the recapitalization of the PWEC  
11 [generation] Assets through a direct loan or loans to PWEC or via the  
12 guarantee of PWEC obligations relating to the PWEC Assets. The  
13 net proceeds of such APS loan(s) to PWEC or the net proceeds from  
14 any issuance of APS - guaranteed PWEC debt would be transferred  
15 by PWEC to Pinnacle West [APS and PWEC's corporate parent] to  
16 repay or refinance a significant portion of the Bridge Debt [of  
17 Pinnacle West]." [Application at page 9, lines 4-9]

18 Such action, however, could have a financial impact on APS, as the following excerpts  
19 clearly indicate:

20 "In connection with such recapitalization or refinancing of the PWEC  
21 Assets, APS may incur additional long-term indebtedness in an  
22 aggregate principal amount of up to \$500,000,000. This would occur  
23 through the issuance or incurring by APS of new indebtedness (such  
24 indebtedness is referred to in this Application as the "Recapitalization  
25 Debt.")" [Application at page 11, lines 2-6]

26 "Although it is the Company's [i.e. APS] firm intent to use unsecured  
27 debt for purposes of the Recapitalization Debt, it is always possible  
28 that market conditions will dictate otherwise. Therefore, the security,  
if any, for any such debt by APS may consist of a mortgage lien on all  
or a portion of the Company's [i.e. APS] assets, third-party credit  
support or other form of security acceptable to both APS and the  
lender." [Application at page 11, line 21-page 12, line 2]

1 Perhaps in recognition of that fact, and in recognition of the unorthodox nature of its request,

2 “As an alternative to the issuance or incurrence of all or a portion of  
3 the Recapitalization Debt, APS also seeks authorization to provide  
4 PWEC with a corporate guarantee or guarantees (‘APS Guarantees’)  
5 of indebtedness (including principal, interest, and associated fees,  
6 charges and expenses) up to an aggregate principal amount of  
\$500,000,000 for a period not to exceed a weighted average life of 10  
years.” [Application at page 12, line 23-page 13, line 3]

7 Suffice it to say, APS is asking the Commission to authorize the company to proceed into  
8 uncharted financial waters for at least this regulatory jurisdiction. Illustrative of this is APS witness  
9 Tildesley’s statement that

10 “This is not a typical situation.” [Tr. 366, lines 22-23]

11 Similarly, during his cross-examination of ACC Staff witness Thornton, APS’ attorney endeavored  
12 to suggest sound financial practices required that APS respond in the manner proposed to address  
13 the liquidity situation of its parent company. However, quite wisely and appropriately, Mr. Thornton  
14 did not “go there.” Rather, he responded

15 “Well, actually we’re in a very gray area here. It would be hard to say  
16 one way or the other.” [Tr. 998, line 22-TR 999, line 2]

17 Further, moments later, Mr. Thornton observed that

18 “. . . the whole application is rather unique and unusual.” [Tr. 1003,  
19 lines 4-5]

20 Against this background, it is imperative that the Commission proceed cautiously and conservatively  
21 in evaluating and acting upon the several authorization requests set forth in APS’ Application; and  
22 that its decision not have the effect, in any conceivable way, of (i) undercutting the Commission’s  
23 efforts to facilitate the development of a viable competitive wholesale electric market through the  
24 Track “B” process or (ii) positioning the Commission to prejudge the resolution of issues not before  
25 it relating to the possible acquisition and rate-basing by APS of PWEC’s generation assets.  
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II.

APPLICABLE DECISION MAKING STANDARDS  
AND BURDEN OF PROOF

A. Statutory Criteria

APS's Application and its requested authorizations have been submitted pursuant to A.R.S. §§40-285, 40-301 *et seq.* and A.A.C. R14-2-804. However, only A.R.S. §40-301 *et. seq* provides any overall guidance with regard to how the Commission should weigh the evidence and exercise its discretion in ruling upon APS' request. A.R.S. §40-285(A) merely states, in pertinent part, that

“A public service corporation shall not . . . mortgage or . . . encumber the whole or part of its . . . plant, or system necessary or useful in the performance of its duties to the public . . . without first having secured from the Commission on order authorizing it to do so. . .”

The statute does not provide the Commission with any specific guidance as to how it should decide whether such an authorization should be forthcoming.

The statutory structure and content is quite different under A.R.S. §40-301 *et. seq.*; and, it is readily apparent that the decision making standards therein prescribed should control the Commission's weighing of the evidence and exercise of its discretion in this proceeding.<sup>2 and 3</sup> More

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<sup>2</sup> Despite his suggestion that the Commission look at “the totality of the situation,” APS witness Davis agreed that A.R.S. §40-301(C) specifies what the Commission must find before it can approve a requested financing authorization; and that the statute prescribes decision making criteria the Commission is to use. [Tr. 425, Line 15- Tr. 428, Line 22]

<sup>3</sup> A.A.C. R14-2-804 is a rule promulgated by the Commission which provides for Commission review of transactions between public utilities and their affiliates. In pertinent part, it provides that a public service corporation shall not obtain a financial interest in, or guarantee a financial liability of, an unregulated affiliate, without prior Commission approval. In reviewing such requests, the Commission shall utilize criteria similar to some of the criteria prescribed by statute in A.R.S. §40-301 *et. seq.*

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specifically, A.R.S. §40-301(C) provides as follows:

“The Commission shall not make any order or supplemental order granting any application as provided by this article unless it finds that such issue is for lawful purposes which are within the corporate powers of the applicant, are compatible with the public interest, with sound financial practices, and with the proper performance by the applicant of service as a public service corporation and will not impair its ability to perform that service.” [emphasis added]

Further, A.R.S. §40-302(A) incorporates these standards by reference as the “purposes” to and for which a given financial authorization may relate; and A.R.S. §40-302(B) provides that the Commission “may attach to its permission conditions it deems reasonable and necessary” in order to assure the prescribed decision making standards are satisfied.

**B. Applicant’s Burden of Proof.**

In proceedings conducted pursuant to A.R.S. §40-301 *et. seq.*, the Applicant has the burden of demonstrating by “clear and convincing evidence” that the decision making criteria therein prescribed have been satisfied. In the instant proceeding, the responsibility for discharging that probative burden lies with APS; and it is for the Commission to determine whether that responsibility has been fulfilled in this instance as to each of the standards set forth in A.R.S. §40-301(C). As the following discussion suggests, Sempra/ SWPG believe serious questions exist as to whether APS has satisfactorily discharged its probative burden under several of these standards.

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3 (cont’d) “The Commission will . . . 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.”

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III.

**A REVIEW OF THE EVIDENTIARY RECORD AGAINST  
A BACKGROUND OF THE STANDARDS OF A.R.S. §40-301(C)**

**A. Introduction**

As noted in Section II(A) above, the Commission “shall not make any order” granting any application filed pursuant to A.R.S. §40-301 *et. seq.*, “unless it finds” that the requested financial authorization satisfies the standards prescribed in A.R.S. §40-301(C). In each instance, the requested authorization must be for a “lawful purpose,” which is also each of the following: (i) “. . . within the corporate powers of the applicant”; (ii) “. . . compatible with the public interest”; (iii) “. . . compatible . . . with sound financial practices”; (iv) “. . . compatible . . . with the proper performance by the applicant of service as a public service corporation”; and (v) “. . . will not impair its ability to perform that service.” If the Commission finds that one or more of these statutory criteria have not been satisfied, it cannot grant the Application pending before it.

**B. Within the Corporate Powers of the Applicant**

The record in this proceeding contains no direct evidence that the alternative forms of financial assistance proposed by APS to be extended to its unregulated generation affiliate and its corporate parent are within its corporate powers. Its policy witness, Jack Davis, assumed that they were. But, Mr. Davis acknowledged during cross-examination that he did not in fact know that to be the case. [Tr. 429, lines 6- 11] Similarly, ACC Staff witness Thornton acknowledged that he had not conducted such an investigation as a part of his assignment, and thus did not know if APS’ requests are within its corporate powers. [Tr. 909, Line 15-Tr. 910, Line 13]

1           During the public hearings, after this issue had arisen, APS did ask the Chief Administrative  
2 Law Judge to take official notice of the company's Articles of Incorporation. However, more than  
3 official notice by the Commission is needed for APS to successfully discharge its probative burden.  
4 As noted above, APS must demonstrate by clear and convincing evidence that the authorization it  
5 seeks is within its corporate powers, and it has failed to do so. In that regard, the following  
6 observations are in order.  
7

8           First, in APS' Articles of Incorporation, Restated as of May 25, 1988, Article Second states  
9 as follows:  
10

11                   "The purposes for which this Corporation is organized include the  
12 transaction of any or all lawful business for which corporations may  
13 be incorporated under Chapter 1 of Title 10, Arizona Revised  
14 Statutes, on or at any time after July, 1976."

15                   "The character of the business which the Corporation intends actually  
16 to conduct in the State of Arizona on and for the foreseeable period  
17 after July 1, 1976 is that of a public service corporation within the  
18 meaning of Section 2 of Article 15 of the Constitution of Arizona as  
19 in effect on July 1, 1976." [emphasis added]

20 Thus, the broad "any or all" language set forth in the first "purposes" paragraph, is modified by the  
21 qualifying language of the second paragraph, which is quite specific and limiting as to the intended  
22 purposes of the company and the nature of its business, namely, that of a public service corporation.

23           Second, even when reference is made to the original February 11, 1920 Articles of  
24 Incorporation of Central Arizona Power and Light Company, APS's predecessor-in-interest, no  
25 statement of purposes can be found which would appear to support APS' proposed use of its  
26 financial resources and credit to lend money to its unregulated generation affiliate. On its face, the  
27 following language from Article Second might be argued by APS to support its request for  
28 authorization to extend a guarantee to PWEC and Pinnacle West:

1                   “(a) To guarantee payment to the indebtedness or performance of  
2 obligations incurred for its benefit by other persons or corporation.”  
3 [emphasis added]

4 However, in order to do so, APS would have to first demonstrate that this earlier language was not  
5 superseded by the above-quoted 1988 language.<sup>4</sup> Further, it would have to demonstrate that the debt  
6 now proposed to be refinanced with its assistance was originally incurred for its benefit by PWEC  
7 and Pinnacle West, which may be quite difficult to do since that debt was incurred at a point in time  
8 when PWEC was being groomed to be an active merchant generator, and no one contemplated the  
9 circumstances which subsequently occasioned the Commission’s issuance of Decision No. 65154.  
10  
11 In any case, APS has demonstrated neither.

12                   In view of the preceding discussion, it appears that APS has not met its burden of  
13 demonstrating that the requested authorizations would be for lawful purposes which are within its  
14 corporate powers and intended corporate purposes.

15                   **C.     Compatible with the Public Interest**

16                   The starting point for the Commission under this standard is a determination of what is the  
17 “public interest” against which the compatibility of APS’ alternative financing proposals is to be  
18 measured. Is it the preservation of PWEC’s generation assets as a future source of power supply for  
19 APS, as APS appears to suggest?<sup>5</sup> Is it the forbearance from any Commission action in this  
20 proceeding which might inhibit the competitive wholesale market the Commission seeks to develop  
21 through the Track “B” proceeding? Is it doing that which is necessary to keep APS financially sound,  
22  
23

24 <sup>4</sup> This might prove to be problematic for APS, inasmuch as the August 11, 1988 Restated Articles  
25 of Incorporation expressly state that the same “supersede the original Articles of Incorporation and  
26 all amendments thereto.”

27 <sup>5</sup> In this regard, APS made no showing that these assets would not be available to serve APS’ future  
28 needs in the event they were sold to a third party.

1 but nothing further, including the gratuitous financial support of APS' unregulated generation  
2 affiliate and its corporate parent?<sup>6</sup>

3  
4 However, as noted above, it is for the Commission to ultimately determine what constitutes  
5 the "public interest" in the context of A.R.S. §40-301(C) and the circumstances surrounding this  
6 proceeding. Similarly, it is the Commission which shall decide whether APS has met its burden of  
7 proof that the requested financing authorizations are "compatible with the public interest" in this  
8 instance. ACC Staff has emphasized throughout the Track A and Track B proceedings that  
9 precipitated APS' application that the relevant public interest is the provision of reliable electric  
10 service to Arizona consumers at the lowest possible price. To date, APS has demonstrated no  
11 credible nexus between that interest and its desire to provide credit support to its parent and affiliate.  
12 To the contrary, granting APS the authorization it seeks would in some measure increase the  
13 financial risk to APS, thereby potentially impairing its ability to serve its customers. In the absence  
14 of an affirmative finding that the financing support APS wishes to provide PWCC/PWEC is in the  
15 public interest, supported by clear and convincing evidence, the Commission should deny the  
16 Application.  
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19 Only after the Commission has determined what public interest is at stake may it proceed to  
20 decide whether APS' financing authorization requests are "compatible" with that interest. Sempra/  
21 SWPG believe that it is imperative that the Commission not do anything in ruling upon APS'  
22 Application which could undercut or dilute the Commission's efforts to facilitate the development  
23 of a viable competitive wholesale electric market through the Track "B" proceeding. Similarly, they  
24

25  
26 \_\_\_\_\_  
27 <sup>6</sup> It is to be remembered that APS offered no actual proof that its own credit would be downgraded  
28 as a consequence of a downgrading of PWEC or Pinnacle West. Rather, it offered only conjecture.

1 believe that the Commission should not do anything in this proceeding which could in any way,  
2 directly or indirectly, have the effect of prepositioning the Commission as to how it may resolve in  
3 proceedings not yet instituted the questions of whether APS should be allowed to acquire or rate base  
4 PWEC's generation assets. In Sempra/SWPG's view, either such undercutting or prepositioning  
5 would clearly be incompatible with the "public interest," as would the authorization of any financing  
6 proposals which led to such results. Similarly, Sempra/ SWPG believe the Commission should  
7 avoid any course of action that entails a risk of putting the Commission on the proverbial "slippery  
8 slope" to such undercutting or prepositioning.  
9

10  
11 **D. Compatible with Sound Financial Practices**

12 In determining whether APS' requested authorizations are compatible with sound financial  
13 practices, the Commission must determine the effect of an implementation of such authorizations  
14 upon APS, not its generation affiliate or its corporate parent. It is the regulated public service  
15 corporation which is the object of interest and concern under A.R.S. 40-301(C), and A.A.C. R14-2-  
16 804(C). This is particularly so where the circumstances present the Commission with a "gray area"  
17 situation and an Application which "is rather unique and unusual."  
18

19 In this regard, it is not enough to simply examine what APS believes is appropriate or  
20 compatible, as its counsel appeared to suggest during his cross-examination of ACC Staff witness  
21 Thornton. [Tr. 998, line 22- Tr. 997, line 7]. Rather, as Mr. Thornton earlier observed, the question  
22 is whether the end result is something which in fact will "help APS." [Tr. 998, lines 7-12] That is  
23 a determination only the Commission can make; and, in so doing, it must also ascertain if APS has  
24 met its burden of proof under this portion of the decision making standards set forth in A.R.S. 40-  
25 301(C). If it has not, APS' Application should be denied. Given the "unique and unusual" nature  
26  
27

1 of its request(s), the burden of proof to be required of APS perhaps should be higher in this “gray  
2 area” than otherwise might be the case. In this regard, as previously noted, the record contains no  
3 credible evidence that APS’ creditworthiness or financial integrity would be impaired if the financing  
4 authorization requests set forth in its Application were to be denied.  
5

6 **E. Compatible with Proper Performance as a Public Service Corporation**

7 The fourth standard under A.R.S. §40-301(C) is whether the authorizations requested are  
8 compatible with APS’ proper performance of its role as a public service corporation. That role and  
9 those obligations are defined and set forth at Article 15, §2 of the Constitution of the State of  
10 Arizona, and various provisions of Title 40 of the Arizona Revised Statutes, and are limited to APS’  
11 role as a public utility.<sup>7</sup> On the face of it, the use of its creditworthiness and financial resources by  
12 APS to prop up an unregulated generation affiliate, and to financially back-stop its unregulated  
13 corporate parent, would appear to have nothing to do with the proper performance of its role and  
14 obligations as a public service corporation. In fact, APS has successfully argued to the Court of  
15 Appeals that its parent company is not a public service corporation, and therefore should be estopped  
16 now from claiming that financial support for that parent is compatible with its role as a public service  
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23 <sup>7</sup> Article 15 §2 provides that: All corporations other than municipal engaged in furnishing gas, oil,  
24 or electricity for light, fuel, or power; or in furnishing water for irrigation, fire protection, or other  
25 public purposes; or in furnishing, for profit, hot or cold air or steam for heating or cooling purposes;  
26 or engaged in collecting, transporting, treating, purifying and disposing of sewage through a system,  
27 for profit; or in transmitting messages or furnishing public telegraph or telephone service, and all  
28 corporations other than municipal, operating as common carriers, shall be deemed public service  
corporations.

1 corporation.<sup>8</sup>

2 APS has the probative burden of affirmatively demonstrating, with credible evidence, that  
3 provision of the proposed type(s) of financial assistance to its unregulated generation affiliate and  
4 corporate parent has a direct bearing upon its ability to properly perform as a public service  
5 corporation in the provision of electric service to its ratepayers. That burden cannot be satisfactorily  
6 discharged with conjecture or innuendo. In turn, it is for the Commission to determine whether APS  
7 has satisfied the burden of proof required of it. As previously noted, if it has not, the requested  
8 financing authorizations must be denied.  
9

10  
11 **F. Will Not Impair Ability to Properly Perform As A Public Service Corporation.**

12 The final decision making standard is whether the authorization requested could impair APS'  
13 ability to properly perform its obligations as a public service corporation. As previously noted in  
14 Section I above, in its own Application APS' acknowledges that the financial community may  
15 require it to secure with "a mortgage lien on all or a portion of the Company's assets" the debt it  
16 proposes to incur on behalf of its unregulated generation affiliate. [Application at page 11, line 21-  
17 page 12, line 2] Given this acknowledged uncertainty, and prospect, APS is simply in no position  
18 at this time to demonstrate that approval of its Application might not impair its ability to properly  
19 perform its public service obligations at some future date by reason of such action.  
20

21 The very existence of such a mortgage lien would, by its very nature, restrict APS' ability to  
22 use its assets to borrow or bond for its own needs from what would otherwise be the case. As a  
23 consequence, there would appear to be negative effect on APS' creditworthiness. Any negative  
24

25 <sup>8</sup> Az. Pub. Svc. Co. v. Az. Corp. Comm., 746 P.2d 4; 155 Ariz. 263 (Ariz. Ct. App. 1987), *reversed*  
26 *on other grounds*, Az. Pub. Svc. Co. v. Az. Corp. Comm., 760 P.2d 532; 157 Ariz. 532, (Ariz. 1988).

1 impact on APS' credit is significant, even if that impact cannot be quantified at this time. Under  
2 these circumstances, a serious question exists as to whether APS has satisfied that burden required  
3 of it under this statutory criterion. It is not enough to simply suggest that APS may not be  
4 downgraded.  
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**IV.**  
**CONCLUSION**

In the preceding sections of this Initial Brief, Sempra/SWPG have discussed (i) the unique nature of the financing authorizations requested by APS, (ii) the statutorily prescribed decision making standards applicable to this proceeding and APS' Application, (iii) the burden of proof to be required of APS as the Applicant, and (iv) the evidentiary record viewed against a background of those decision making standards and APS' probative burden. It is for the Commission to determine whether APS has discharged its probative burden, and whether each of the statutory criteria set forth in A.R.S. §40-301(C) have been satisfied. In the event the Commission should reach a negative conclusion as to one or more of these criteria, the Commission must deny APS' Application.

Further, and in any event, the Commission's Decision should not have the effect, in any conceivable way of, (i) undercutting the Commission's efforts to facilitate the development of a viable competitive wholesale electric market through the Track "B" process or (ii) positioning the Commission to prejudge the resolution of issues not before it relating to the possible acquisition and rate-basing by APS of PWEC's generation assets.

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