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BEFORE THE ARIZONA CORPORATION COMMISSION

SPITZER  
CHAIRMAN Arizona Corporation Commission

JIM IRVIN  
COMMISSIONER

WILLIAM A. MUNDELL  
COMMISSIONER

MIKE GLEASON  
COMMISSIONER

JEFF HATCH-MILLER  
COMMISSIONER

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Arizona Utility  
Investors Association

2100 N. Central, Ste. 210  
P. O. Box 34805  
Phoenix, AZ 85067

Tel: (602) 257-9200  
Fax: (602) 254-4300

Email: info@auia.org  
Web Site: www.auia.org

IN THE MATTER OF THE APPLICATION OF )  
ARIZONA PUBLIC SERVICE COMPANY 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 GUARANTEE THE )  
OBLIGATIONS OF AN AFFILIATE OR AFFILIATES )

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AUIA'S OPENING POST-HEARING BRIEF

Pursuant to the direction of the Chief Administrative Law Judge at the close of hearing Jan. 14, 2003, the Arizona Utility Investors Association (AUIA) hereby submits its initial post-hearing brief in the above-captioned matter.

INTRODUCTION

Every party that has filed testimony in this proceeding accepts the fact that the generating facilities owned by Pinnacle West Energy Corp. (PWEC) must be refinanced in 2003. The question at issue is how they should be financed.

Arizona Public Service Co. (APS) and its parent, Pinnacle West Capital Corp. (PWCC), have launched a multi-pronged recovery plan to deal with the billion-dollar debt burden associated with these facilities. A proposed \$500 million loan or guarantee from APS to one of the affiliates is just one component of the plan and it is the focus of this proceeding.

In order to approve the APS application, the Commission should find that the transaction is in the public interest. In our view, the application meets that test if it minimizes or reduces the risk of higher capital costs to APS and its customers through credit downgrades.

1 For guidance, four of the five parties that have filed testimony in this  
2 proceeding have endorsed the APS plan and concluded that approval of the  
3 application would be in the public interest. Those parties are APS, AUIA,  
4 Commission Staff and the Residential Utility Consumers Office (RUCO).

5 The dissenting party is Panda Gila River L.P. (Panda), which insisted in  
6 pre-filed testimony that the refinancing should take place at PWCC, without the  
7 involvement of APS.

8 AUIA believes that the evidence adduced at hearing solidly supports  
9 Commission approval of the APS application, albeit with certain conditions, and  
10 thoroughly discredits Panda's arguments against the plan and its alternate  
11 financing proposal.

## 12 **POSITIONS OF THE PARTIES**

### 13 **1. Arizona Public Service Co.**

14 The generating units covered by the PWEC debt include West Phoenix CC  
15 Units 4 & 5, Redhawk Units 1 & 2, Saguaro CT Unit 3 – collectively, the Arizona  
16 reliability units – plus the Silverhawk facility under construction in Clark  
17 County, Nev.<sup>1</sup>

18 Although the obligation associated with Silverhawk is covered in the  
19 overall plan to restructure the PWCC /PWEC debt, none of the proposed APS  
20 loan or guarantee would be devoted to Silverhawk,<sup>2</sup> and it is not included in the  
21 financing application.

22 According to APS, the total debt at PWCC as of last July 1 was \$959  
23 million, including \$635 million of bridge financing devoted to PWEC assets,  
24 which will grow to \$765 million by mid-2003. Of that amount, \$550 million will  
25 mature this year and another \$215 million will come due in early 2004.<sup>3</sup>

26 According to APS finance witness Barbara Gomez, the plan to deal with  
27 the PWCC debt has several components,<sup>4</sup> including:

- 28 • The proposed authorization in the financing application for APS to loan  
29 or guarantee up to \$500 million of PWCC or PWEC debt.
- 30 • The recent issuance of some \$200 million of PWCC common stock.
- 31 • The accelerated sale of affiliate assets, primarily in Suncor, to produce  
32 \$80 to \$100 million in cash per year<sup>5</sup>

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<sup>1</sup> Application, P. 1, L. 16-19

<sup>2</sup> Tr., P. 289, L. 21-25

<sup>3</sup> Application, P. 8, L. 17-24

<sup>4</sup> APS Ex. 1, P. 19, L. 3-10

<sup>5</sup> Tr. P. 759, L. 4 – P.760, L. 1

1           • The sale of one-fourth of the output of Silverhawk to the Southern  
2 Nevada Water Authority.<sup>6</sup>

3           Ms. Gomez asserted that one objective of the plan is to reduce PWCC's  
4 total debt to approximately \$400 million by 2005.<sup>6</sup>

5           Ms. Gomez testified that the proposed APS loan authority carries nearly  
6 "zero" credit risk to APS and its customers<sup>7</sup> and she cited documentation from  
7 rating agencies that offered favorable views of the APS refinancing plan.<sup>8</sup>

8           On the contrary, she said, refinancing solely at PWCC, without APS's  
9 involvement, would be nearly "impossible."<sup>9</sup> She asserted that rating agencies  
10 would react negatively to such a scheme and that it would result in downgrades  
11 to PWCC's investment grade credit ratings, which would also produce negative  
12 impacts on APS.<sup>10</sup>

13           Ms. Gomez testified that the proposed loan authority would not affect  
14 APS's ability to fund capital investments because the company expects to finance  
15 its capital needs with internally generated funds over the next four years rather  
16 than accessing the capital markets.<sup>11</sup>

17           On cross-examination, Ms. Gomez was asked to comment on the  
18 likelihood of a so-called default scenario in which PWEC would simply fail to  
19 perform on the loan and APS would automatically acquire the assets. Ms.  
20 Gomez responded that such a scenario offered no benefit to APS or PWCC, citing  
21 cross-default penalties to PWCC and auction requirements in the security  
22 agreements that would prevent an automatic transfer to APS.<sup>12</sup>

23           With regard to the guarantee option, Ms. Gomez testified that APS could  
24 accept the authority to issue either a loan or a guarantee, but that the loan is a  
25 simpler transaction more readily understood by the financial community,  
26 including the rating agencies.<sup>13</sup>

27           Finally, Ms. Gomez testified regarding APS's response to the seven  
28 conditions to the loan approval proposed by the Commission Staff. Ms. Gomez  
29 asserted that APS agreed to the Staff's conditions,<sup>14</sup> with one exception. She  
30 asserted that Condition 3, imposing an interest premium of 264 basis points

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<sup>6</sup> APS Ex. 1, P. 19, L. 16-22

<sup>7</sup> Tr., P. 88, L. 21-24

<sup>8</sup> Tr., P. 92, L. 18 - P. 93, L. 4

<sup>9</sup> Tr. P. 90, L. 1-11

<sup>10</sup> Tr., P. 90, L. 12 - P. 91, L. 18

<sup>11</sup> APS Ex. 1, P. 10, L. 6-9

<sup>12</sup> Tr., P. 82, L. 12 - P. 84, L. 11

<sup>13</sup> APS Ex. 1, P. 14, L. 23 - P. 15, L. 3

<sup>14</sup> APS EX. 2, P. 4, L. 10 - P. 6, L. 23

1 above APS's cost of borrowing, is punitive and that a market-based premium  
2 would approximate 150 basis points.<sup>15</sup>

3 APS witness Jack Davis testified regarding the potential relationship  
4 between Commission approval of the financing application and its subsequent  
5 decisions regarding rate basis treatment of the PWEC units.

6 Ms. Gomez testified and Mr. Davis confirmed that APS intends to seek  
7 rate base treatment of the PWEC facilities in its next rate case.<sup>16</sup> However, he  
8 asserted that, in approving the financing application, the Commission would not  
9 be bound to any particular course of action regarding the PWEC units.<sup>17</sup>

10 Mr. Davis postulated that the Commission could have several options for  
11 dealing with the PWEC units and he noted, for example, that Unit 3 of the Palo  
12 Verde Nuclear Generating Station was in service for several years before the  
13 Commission declared its full capacity to be used and useful.<sup>18</sup>

## 14 **2. Commission Staff**

15 It is clear from a full reading of Staff witness John Thornton's testimony  
16 that the Staff does not regard this as an every day, garden variety financing  
17 application.

18 However, Mr. Thornton agrees with the applicant that a deterioration of  
19 PWCC credit ratings would also drag down APS.<sup>19</sup> He concludes that the  
20 requested loan authority would be consistent with the public interest if it helped  
21 to prevent a decline in APS's credit ratings.<sup>20</sup>

22 To keep the loan authority consistent with APS's role as a public service  
23 corporation,<sup>21</sup> and to prevent negative consequences, such as a decline in APS's  
24 financial ratios,<sup>22</sup> Mr. Thornton proposes a series of seven conditions.<sup>23</sup> The  
25 effects of those conditions are as follows:

- 26 1. Limits APS to a maximum of \$500 million of new debt.
- 27 2. Requires APS to obtain a security interest in the PWEC units.
- 28 3. Sets the premium on the PWEC note at 264 basis points above the  
29 coupon on APS debt.

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<sup>15</sup> APS Ex. 2, P. 5, L. 3 -13; Tr., P. 102, L. 17 - P. 104, L. 3

<sup>16</sup> APS Ex. 2, P. 11, L. 20-23; Tr., P. 410, L. 14-15

<sup>17</sup> Tr., P. 410, L. 8-14

<sup>18</sup> Tr., P. 410, L. 16 - P. 411, L. 20

<sup>19</sup> Staff Ex. 1, P. 4, L. 13-15

<sup>20</sup> Staff Ex. 1, P. 4, L. 15-17

<sup>21</sup> Staff Ex. 1, P. 5, L. 14-20

<sup>22</sup> Staff Ex. 1, P. 8, L. 9-10

<sup>23</sup> Staff Ex. 1, P. 11, L. 17 - P. 12, L. 13

- 1 4. Requires the difference in income resulting from the premium to be
- 2 deferred as a credit to reduce future customer rates.
- 3 5. Limits the PWEC debt maturity to four years.
- 4 6. Prohibits any demonstrable increase in APS's cost of capital resulting
- 5 from this transaction from being included in future rates.
- 6 7. Precludes APS from paying dividends to PWCC if its common equity
- 7 ratio falls below 40%.

8 Mr. Thornton recommends that the financing application should be  
9 approved, subject to these conditions.<sup>24</sup> He notes that if APS sold the proposed  
10 \$500 million in debt, its capitalization ratios would be appropriate, at 55% equity  
11 and 45% debt.<sup>25</sup>

12 As we noted previously, Ms. Gomez on behalf of APS accepted the Staff  
13 conditions, except for her objection that an appropriate premium on the PWEC  
14 note would approximate 150 basis points. On cross-examination, Mr. Thornton  
15 asserted that his proposed premium would amount to about \$60 million over  
16 four years, but he insisted that it is not punitive.<sup>26</sup>

17 Finally, Mr. Thornton expressed Staff's view that an APS loan is preferable  
18 to the guarantee option, which he said suffers from a lack of definition.<sup>27</sup>

### 19 3. RUCO

20 RUCO also supports approval of the financing application, although from  
21 a somewhat different perspective than other parties that support the application.  
22 RUCO's witness, Marylee Diaz Cortez, sums up her organization's position in  
23 this statement:

24 "Allowing PWEC, and as a result PWCC, to default on its debt and enter  
25 bankruptcy is not in the public interest. APS, notwithstanding potential ravages  
26 to its affiliates, must remain sound to serve the public interest. It is therefore far  
27 more prudent to design a rescue plan to prevent financial collapse of PWEC  
28 rather than stand aside, watch its collapse, and attempt to clean up the wreckage  
29 afterward."<sup>28</sup>

30 However, RUCO regards the proposed APS financing as a stopgap  
31 measure, which should lead to "a cohesive comprehensive plan to rebuild the

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<sup>24</sup> Staff Ex. 1, P. 14, L. 4-6

<sup>25</sup> Staff Ex. 1, P. 13, L. 16-18

<sup>26</sup> Tr., P. 980, L. 5-19

<sup>27</sup> Staff Ex. 1, P. 7, L. 16-21

<sup>28</sup> RUCO Ex. 1, P. 8, L. 5-10

1 regulatory paradigm and return the electric industry in Arizona to functional  
2 viability."<sup>29</sup>

3 RUCO is also uncomfortable over the long term with APS assuming  
4 financial responsibility for assets it doesn't own and recommends that approval  
5 of the financing application be conditioned on APS filing an application for the  
6 transfer of the PWEC generating assets to APS within 45 days after an order is  
7 issued in this proceeding.<sup>30</sup>

8 Since it is understood that APS expects to file a rate case application in  
9 approximately June of this year and that it will include a request to include the  
10 PWEC reliability units in rate base, it would appear that RUCO's proposed  
11 condition is largely unnecessary.

12 Furthermore, it is unclear what financial purpose would be served by  
13 having APS loan \$500 million to an affiliate and then move immediately to  
14 acquire the assets with an application that the Commission probably would not  
15 consider outside of a rate case.

#### 16 **4. Arizona Utility Investors**

17 AUIA supports the APS financing application as the safest method of  
18 curing the bridge debt dilemma facing PWEC and PWCC. According to AUIA  
19 witness Walter Meek, AUIA doubts that Pinnacle West could undertake  
20 refinancing absent APS's participation without sustaining serious and  
21 unacceptable blows to its current credit rating and its financing costs.<sup>31</sup>

22 Mr. Meek asserts also that APS, as the underlying source of cash flow,  
23 could be penalized in the financial markets by any credit damage sustained by  
24 Pinnacle West.<sup>32</sup> He pointed out that the rating agencies clearly signaled that  
25 credit downgrades are in store for both PWCC and APS if the Commission does  
26 not approve an acceptable refinancing plan.<sup>33</sup>

27 AUIA is alarmed that if APS's credit cannot be utilized in a refinancing  
28 plan, it is possible that a bankruptcy or forced sale of some or all of the PWEC  
29 generating assets could occur.<sup>34</sup>

30 Mr. Meek also argues that new issues of common equity should not be  
31 employed as the chief strategy for addressing the PWEC debt problem because it

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<sup>29</sup> RUCO Ex. 1, P. 13, L. 16-19

<sup>30</sup> RUCO Ex. 1, P. 12, L. 6-14

<sup>31</sup> AUIA Ex. 1, P. 4, L. 22-25

<sup>32</sup> AUIA Ex. 1, P. 4, L. 26-27

<sup>33</sup> AUIA Ex. 1, P. 4, L. 30-33

<sup>34</sup> AUIA Ex. 1, P. 5, L. 2-5

1 is an expensive solution that would impact ratepayers and because it would not  
2 be well received by the financial markets.<sup>35</sup>

### 3 **5. Panda Gila River**

4 Unfortunately for Panda, its chief argument opposing the APS financing  
5 application was invalidated by an intervening event midway through the  
6 proceeding.

7 Panda's witness, Susan Abbott, threw down the credit ratings gauntlet  
8 early in her direct testimony with the statement that the APS recovery plan has  
9 "a very real likelihood" of a credit downgrade for APS.<sup>36</sup>

10 Later, Ms. Abbott asserted that, "the financial community will become  
11 alarmed" if APS is allowed to incur more debt<sup>37</sup> and that a new financing at APS  
12 would diminish APS's overall credit quality, resulting in higher borrowing  
13 costs.<sup>38</sup>

14 Ultimately, she predicted that Moody's Investors Service "would  
15 downgrade APS' rating by at least one notch because the important financial  
16 metrics by which they derive their ratings will deteriorate."<sup>39</sup> She then devoted  
17 eight pages of her testimony to demonstrating how Moody's and other rating  
18 agencies would analyze the refinancing at APS.<sup>40</sup>

19 Unfortunately for Ms. Abbott, Moody's issued an update opinion on Dec.  
20 30, after her testimony was filed, which approved the Staff's proposal on the APS  
21 financing<sup>41</sup> and vaporized the heart of Ms. Abbott's argument.

22 On cross-examination, Ms. Abbott admitted that she had no evidence that  
23 her downgrade prediction applied to Standard & Poor's<sup>42</sup> and that it was simply  
24 not true regarding Moody's.<sup>43</sup>

25 Based on Ms. Abbott's testimony, Panda's alternative to the APS financing  
26 plan is to consolidate the refinancing of the PWEC debt at the parent company,  
27 PWCC.<sup>44</sup> She opined that the financial community would view a refinancing at  
28 PWCC "as a reasonable investment,"<sup>45</sup> although she could not explain why it  
29 would not be just as reasonable for APS.<sup>46</sup>

30 Ms. Gomez asserted that PWCC would be unable to support that level of  
31 debt and retain its credit ratings<sup>47</sup> and that such a scheme would be impossible to

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<sup>35</sup> AUJA Ex. 1, P. 6, L. 11-29

<sup>36</sup> Panda Ex. 22, P. 2, L. 9-19

<sup>37</sup> Panda Ex. 22, P. 10, L. 11-13

<sup>38</sup> Panda, Ex. 22, P. 10, L. 21-24

<sup>39</sup> Panda Ex. 22, P. 19, L. 6-7

<sup>40</sup> Panda Ex. 22, P. 19, L. 6 - P. 26, L. 10

<sup>41</sup> Tr., P. 94, L. 20 - P. 96, L. 20

<sup>42</sup> Tr., P. 753, L. 16-25

<sup>43</sup> Tr., P. 754, L. 8-11

<sup>44</sup> Panda Ex. 22, P. 7, L. 16-17

<sup>45</sup> Panda Ex. 22, P. 11, L. 12-14

<sup>46</sup> Tr., P. 764, L. 2 - P. 765, L. 24

<sup>47</sup> APS Ex. 1, P. 10, L. 1-7

1 carry out successfully.<sup>48</sup> Furthermore, she noted that the Staff's conditions should  
2 moot all of Ms. Abbot's professed concerns about the APS financing.<sup>49</sup>

### 3 CONCLUSION

4 It is no accident that four of the five parties that have filed testimony in  
5 this proceeding support the APS financing plan in one form or another, i.e., with  
6 or without conditions.

7 All of them recognize that it makes more sense to put a recovery plan in  
8 place that relies on APS's demonstrated credit quality and capacity than to risk  
9 the downgrades that would surely accompany a refinancing based on Pinnacle  
10 West's resources alone.

11 The record demonstrates that APS might be unable to escape the negative  
12 consequences of a loss of credit quality at Pinnacle West and there could be a  
13 resulting impact on the cost of serving APS customers.

14 The overall plan to address the PWCC debt includes not only the \$500  
15 million APS loan authority, but also a number of other features, such as recently  
16 issued common equity, accelerated sales of real estate assets and operating cost  
17 savings.

18 The principal opposition comes from Panda-Gila River, whose dissenting  
19 argument is based on the threat that the rating agencies would downgrade APS's  
20 credit quality because of the increased debt burden. That argument was  
21 thoroughly discredited by the published responses of the rating agencies to the  
22 APS financing proposal.

23 Panda's alternative is to require the refinancing to occur at Pinnacle West,  
24 a strategy that is rejected by all of the other parties as too risky for APS and its  
25 customers.

26 All other considerations aside, the evidence points to the conclusion that  
27 the Staff's conditions, if adopted by the Commission, obviate the concerns raised  
28 by Panda.

29 AUIA urges the Commission to approve the APS financing application, as  
30 modified by the Staff's conditions, with the exception of Condition No. 3. AUIA  
31 recommends that this condition should be altered to require an interest premium  
32 of 150 basis points above APS's coupon cost.

33 Although Mr. Thornton denies that his recommendation is punitive,  
34 AUIA cannot help but point out that the incremental difference of \$22-23 million  
35 would amount to a penalty on Pinnacle West shareholders who bear no  
36 responsibility for the circumstances underlying this proceeding.

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<sup>48</sup> APS Ex. 2, P. 18, L. 1-8; Tr., P. 90, L. 1-11

<sup>49</sup> APS Ex. 2, P. 17, L. 17-23

