0000047206

Transcript Exhibit(s)

Docket #(s): E-01345A-02-0707

Exhibit # APS 1-21, (22-25 confidential)
AU/A 1-2, RUCO 1
S1-4 (3 not used), Sempa/SW1

# EXHIBITS

## E-01345A-02-0707

## PART 1 OF 2
## BAR CODE # 0000047206

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## PART 2 OF 2 BAR CODED #0000047207

# APS

# 1 – 25

EXHIBIT
APS-1
Admitted

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

I. INTRODUCTION

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

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

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

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

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

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

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

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

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

## II. SUMMARY

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

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

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

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

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

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

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

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

## III. FINANCING OPTIONS PRIOR TO DECISION NO. 65154

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

A. I was not responsible for PWEC's creation, but as an officer of the Company, I necessarily was aware of the requirement to divest APS generation under the Electric Competition Rules. APS had opposed from the beginning a Commission Staff proposal to require divestiture of the Company's generation 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

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

**Q. WHAT HAPPENED NEXT?**

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

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

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

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

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

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

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

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

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

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

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

## IV. IMPACT OF DECISION NO. 65154

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

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

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

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

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

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

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

> Not only is the amount of debt important, but also its location within the corporate structure. Most of the increase in debt has been at the parent level. . . . The increase in debt at the parent is reflected in ratings in two ways. First, the spread between the parent rating and the operating company 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.

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

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

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

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

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

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

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

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

## V. THE RECOVERY PLAN

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A. First of all, we are asking to be permitted no greater discretion than the Commission granted the Company in both Decision Nos. 55017and 54230 (November 8, 1984), which were the last two major APS financing proceedings. Second, I believe the Company has earned the Commission's confidence that this discretion will be appropriately exercised by its behavior in this regard over the past 17 years. As is noted in the Application, APS has to date issued over $5 billion in long-term debt pursuant to the authority granted in the two cited Commission Decisions since 1985. There has never been a single issue raised, 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

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

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

A. If the guarantee option is utilized, there may be no new debt to count against the cap, and thus the issue would be moot unless the Commission finds that a guarantee in and of itself, although only a secondary and contingent liability, constitutes an "evidence of indebtedness" within the meaning of A.R.S. § 40-301, *et seq*. But whether or not APS actually issues the Recapitalization Debt or a corporate guarantee or some combination of the two, the Company views this as a one time "in and out" transaction and not part of its permanent utility financing program. Consequently, it does not wish this specific transaction or group of transactions, which are only intended to partially "right the ship" that is in danger of foundering as a result of Decision No. 65154, to affect that permanent utility financing program or in any way limit the flexibility of that program. To accomplish this requires that APS maintain the present amount of "headroom" or margin under the long-term debt financing limits established by Decision No. 55017. The present margin is just under $500 million. This margin 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

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

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

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

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

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

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

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

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

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

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

**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?**

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

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

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

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

## VI. IMPACT OF PROPOSED RECOVERY PLAN ON APS

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

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

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

A. I have assumed no payments by PWEC or PWCC on the Repayment Note such that none of the principal amount of the Recapitalization Debt is subsequently repaid by PWEC and thus remains on the Company's balance sheet. Similarly, none of the interest expense of such Recapitalization Debt is shown as offset by interest income from the Repayment Note. In the case of the corporate guarantee, I assume that the rating agencies will completely ignore the primary 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

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

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

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

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

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

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

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

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

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

VII. CONCLUSION

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

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

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

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

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-3

## Financial Impact of Recapitalization Debt
in ($000)

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

## Financial Indicators

| | (A) Per Books June 2002 | (B) Proforma (1) + $500M @ 6% | (C) Rating Agency Approach + $500M @ 6% | (D) S&P "BBB" Targets (2) Business Position 5 |
|---|---|---|---|---|
| **DEBT RATIO** | | | | |
| Adj. Total Debt / Total Capital | 54.4% | 58.7% | 58.7% | 47% - 55% |
| **COVERAGE RATIOS** | | | | |
| 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.

# BMG-2

## Spreads above BBB2-rated Debt

| | |
|---|---|
| BBB3 | 1.55% |
| BB | 2.80% |

Source: Bloomberg, 9/11/02

# BMG-1

## PWEC

### Contingent Credit Ratings

| | |
|---|---|
| Moody's | Baa2 |
| S & P | BBB |
| Fitch | BBB+ |

EXHIBIT
APS-2
Admitted

# REBUTTAL TESTIMONY OF BARBARA M. GOMEZ

**On Behalf of Arizona Public Service Company**

**Docket No. E-01345A-02-0707**

**December 30, 2002**

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SCHEDULE BMG-1R.....S&P PRESS RELEASE OF NOVEMBER 4, 2002

SCHEDULE BMG-2R.....FITCH REPORT OF DECEMBER 4, 2002

SCHEDULE BMG-3R.....FITCH REPORT OF DECEMBER 17, 2002

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

I. INTRODUCTION

**Q. PLEASE STATE YOUR NAME.**

A. Barbara M. Gomez.

**Q. HAVE YOU PREVIOUSLY SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING?**

A. Yes.

**Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?**

A. I will respond to some of the statements and conclusions of both Utilities Division Staff ("Staff") witness John S. Thornton, Jr., and intervenor Panda Gila River, L. P. ("Panda/TECO") witness Susan Abbott. I will also discuss the various conditions Staff would impose on the Arizona Corporation Commission's ("Commission") approval of Arizona Public Service Company's ("APS" or "Company") Application.

II. SUMMARY

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

APS is greatly encouraged by the fact that both Staff and the Residential Utility Consumer Office ("RUCO") have recommended approval of the Company's Application. They recognize in their positive recommendations, as do I, that further deterioration of the financial condition of the Company's parent company, Pinnacle West Capital Corporation ("PWCC"), would have a negative impact on APS. Such continued deterioration would also threaten the ability of

PWCC and Pinnacle West Energy Corporation ("PWEC") to retain control over the PWEC assets used to serve APS. This, in turn, could limit the Commission's ability to consider the inclusion of these generating assets in the Company's rates during the 2003-2004 APS general rate proceeding. This potential rate treatment also appears to be supported by RUCO in its testimony.

The conditions proposed by Staff are intended to protect APS and APS customers from any potential negative impact from the financing itself. Although APS does not believe these conditions are necessary, it is willing to accept them. I will seek to clarify Staff's "Condition No. 7" limiting APS dividends under specified circumstances and will offer an alternative estimate of the interest rate "risk premium" that Mr. Thornton is attempting to measure in Staff's "Condition No. 3."

As much as I agree with Mr. Thornton's conclusions about the need for approving the Application, I do not share all of his views concerning the impact of the proposed financing on APS, the purpose for which that financing is necessary, or the nature of the APS/PWCC relationship. I therefore provide the Commission with additional and updated information that supports the reasonableness of Mr. Thornton's ultimate recommendation to approve the proposed financing.

On the other hand, Ms. Abbott's conclusions are not only unsupported by her analysis, they are flatly contrary to the available evidence. They also do not take into consideration the impact of the strict conditions Staff has proposed for the financing, which conditions largely moot Ms. Abbott's concerns. Finally, as is discussed more directly in APS President Jack E. Davis' Rebuttal Testimony,

Ms. Abbott's presentation fails to recognize or account for the regulatory history leading to the present financial circumstances in which APS and its affiliates now find themselves.

## III. RESPONSE TO STAFF

### *1. Staff's Conditions*

**Q. WHAT CONDITIONS HAS STAFF RECOMMENDED BE ATTACHED TO THE COMMISSION'S APPROVAL OF THE COMPANY'S FINANCING APPLICATION?**

A. These are discussed at pages 11 and 12 of Mr. Thornton's testimony. The conditions include:

1. the debt be limited to no more than $500 million in addition to the Company's existing debt authorization (referred to in my testimony and the Application as "Continuing Debt");

2. the note from PWEC to APS should be callable and secured in in the same manner as required by the Commission in Decision No. 65434 (December 3, 2002);

3. the PWEC note should bear a premium of 264 basis points over an APS secured note for an equivalent term;

4. the difference between the PWEC note's interest income to APS and the interest expense incurred by APS on what the APS Application calls the "Recapitalization Debt" should be recorded as a deferred credit, bearing 6% interest, which would be reflected in the Company's next rate case;

5. the PWEC note should not exceed four years without Commission approval;

6. any demonstrable increase in the APS cost of capital attributable to the transaction between APS and PWEC would be excluded from consideration in future APS rate cases; and,

7. APS would maintain a minimum equity ratio of 40% and could not pay a dividend without Commission approval if its common equity ratio would be reduced below such threshold. APS requests for such Commission approval would be ruled upon within 60 days, during which time the dividend limitation would be suspended.

Although not listed as a condition, Staff has also recommended that the requested authority to issue a guarantee to PWEC or PWCC be denied, as well as Company's alternative request to directly lend $500 million to PWCC to directly retire the Bridge Debt.

**Q. WHAT IS THE COMPANY'S POSITION ON THESE CONDITIONS?**

A. APS can generally accept Staff's conditions if the Commission otherwise approves the Company's Application. I have added the qualifier "generally" because Condition No. 7 requires some clarification and Condition No. 3 should be modified to reflect a more appropriate "risk premium" for the PWEC note to APS. And because some of these conditions are very strict (even onerous), our acceptance of them, though conditional, requires some explanation.

Condition No. 1: This is consistent with the Company's original request.

Condition No. 2: Whether the PWEC note would be callable was not addressed in the Application, but APS certainly has no objection to having that feature added. APS likewise had not proposed to secure the PWEC note unless APS itself issued secured debt, a most unlikely event. Our thinking was to preserve at least the possibility of PWEC issuing additional debt on its own using the PWEC assets as security. Because APS now intends to present its arguments for rate-basing these PWEC assets in the 2003-2004 rate proceeding,

such future PWEC debt may be unnecessary, and thus APS is amenable to securing the PWEC note with these assets.

Condition No. 3: The general concept of charging PWEC or PWCC a premium for the loan from APS is acceptable to APS so long such premium is reasonable and does not become punitive. It should be kept in mind that absent the Commission's blocking divestiture in Decision No. 65154 (September 10, 2002), PWEC would have had a BBB debt rating, roughly comparable to that of APS or at worst, just a notch below. I estimate that this would translate into a risk differential of no more than 150 basis points rather than the 264 basis points suggested by Staff. Similarly, if the loan were made to PWCC (an option requested in the Application but rejected by Staff without explanation) rather than to PWEC, it would suggest approximately the same reduced risk premium. (*See* Direct Testimony of Barbara M. Gomez at Schedule BMG-1.)

Condition No. 4: APS accepts this condition as consistent with both Decision No. 65434 and the recovery of deferred transition costs pursuant to the 1999 APS Settlement and Decision No. 65154.

Condition No. 5: The suggested shorter term of the PWEC note would have been more troublesome but for the decision of the Company to seek rate base treatment of the PWEC assets subject to the usual conditions to such treatment under traditional cost-of-service regulation. With that background and the corresponding ability to ask the Commission to extend the term of the PWEC note, APS can agree to this condition.

Condition No. 6: APS will likewise agree to this condition and believes that no such demonstrable increase in its cost of capital will occur. Indeed, this belief

is consistent with both Mr. Thornton's and my own conclusion that approval of the Application will actually protect the Company's credit. However, APS does not agree to forego recovery of its increased capital costs in the event its Application is denied or is approved with additional or more onerous conditions that themselves cause the Company's cost of capital to increase.

Condition No. 7: A regulator-imposed dividend limitation is an unusual interference with the authority of APS' Board of Directors under any circumstances. In this instance, however, the Company will voluntarily agree to Staff's proposed limitation as a condition to the approval of the Application, similar to the voluntary limitation it agreed to under the 1991 Settlement approved in Decision No. 57649 (December 6, 1991). APS has worked within the confines of such limitations in the past and can do so now so long as Staff's proposed waiver procedure is also adopted.

However, APS would ask that the Commission clarify the 40% equity ratio limitation. By defining this calculation of common equity ratio now, it will avoid the potential for uncertainty surrounding the ability of APS to declare dividends in the future. The Company would calculate that equity ratio on a quarterly basis using its 10 Q or 10 K filings with the Securities and Exchange Commission ("SEC"). Using the reported APS balance sheet amounts, one would divide the APS common equity by the sum of such common equity and APS long-term debt (including current maturities of such debt), again as reported in the 10 Q or 10 K.

**Q. WHAT ABOUT THE STAFF RECOMMENDATIONS CONCERNING THE PROPOSED GUARANTEE OR THE POTENTIAL FOR A LOAN TO PWCC IN LIEU OF ONE TO PWEC?**

A. APS had originally proposed the guarantee option because of its potentially reduced impact on APS and because it might provide PWEC some "credit exposure" in the market that would be valuable in the future. Given the continuing challenges in the financial markets since the time the Application was filed, the guarantee option is more or less moot.

The direct loan to PWCC option was proposed to offer an alternative that might be less costly overall. Mr. Thornton does not give any reason why he has rejected that option, but APS will not pursue this option further if it is not penalized for that forbearance in determining the amount of the interest premium charged by APS to PWEC—an issue discussed earlier in my Rebuttal Testimony.

*2. The Impact of the Loan on APS*

**Q. DO YOU AGREE WITH STAFF WITNESS THORNTON THAT APPROVAL OF THE APPLICATION WILL SUPPORT APS' CREDIT?**

A. Absolutely. In fact, Mr. Thornton states this no less than three times in his testimony. (*See* Testimony of John S. Thornton, Jr., at page. 4, lines 6-7 and 15, and also at page 5, line 19.) This benefit alone satisfies the requirement that the Application be in the public interest.

**Q. IS THE APPLICATION CONSISTENT WITH SOUND FINANCIAL PRACTICES?**

A. Yes. As I explain in my Direct Testimony, it is a sound financial practice to avoid a known and immediate threat to one's credit rating. PWCC's financial peril poses precisely such a known and immediate threat. It is also a sound financial practice to preserve the financial viability of assets used to serve APS customers. I would note that all of the Company's major generating projects

required APS financial and credit support prior to such generation being included in the Company's rate base. In the case of Palo Verde Unit 3, such credit support lasted almost a decade prior to the plant's eventual rate base recognition. And with the Staff conditions, APS may actually "profit" from the transaction, albeit at the expense of PWCC shareholders—a profit that will go directly to the benefit of our customers.

**Q. DOES MR. THORNTON ALSO AGREE?**

A. Mr. Thornton arrives at this same conclusion, although a portion of his testimony could be read as qualifying that support despite his evident belief that the refinancing at APS of the Bridge Debt will help to preserve the Company's own credit. For that reason, I would like to add some context to Mr. Thorton's remarks.

At page 4, line 27 through page 5, line 3, Mr. Thornton states:

> ...it is not necessarily a sound financial practice for APS to use its bonding capacity (the extent to which APS can issue secured debt) for the purpose of purely investing in an affiliate without any business purpose consistent with APS' primary mission. [Emphasis added.]

I have several comments about the preceding statement.

First, APS does not intend to use any of its bonding capacity in issuing the Recapitalization Debt. Even if it were, APS has far more capacity under is mortgage indenture to issue first mortgage bonds (over $3 billion) than the debt authority requested in the Application.

Second, APS is not "purely investing in an affiliate." APS is attempting both to preserve its own credit rating and at least partially address the circumstances

created by the Commission decision not to allow the divestiture of APS generation to PWEC. It is also attempting to preserve the opportunity for Commission rate review of the PWEC assets.

Third, the business purpose for the proposed loan is entirely "consistent with APS' primary mission." As is discussed in Mr. Davis' Rebuttal Testimony, PWEC assets were built to serve APS customers. They already have provided literally billions of kWh to APS and were critical to maintaining reliable service during 2001 and 2002. In a very real sense, these assets are no different from APS generating assets such as Palo Verde Unit 3 that have provided power to APS customers and enjoyed APS credit support for very significant periods prior to being placed into the Company's rate base.

I do agree with Mr. Thornton's observation that the "debt and the assets should normally be held by the same enterprise." (Testimony of John S. Thornton, Jr., at page 6, line 19.) This will, of course, be accomplished if the Company is able to place the collateralized PWEC assets into its rates.

**Q. WILL APS HAVE AN APPROPRIATE DEBT/EQUITY RATIO AFTER ISSUANCE OF THE RECAPITALIZATION DEBT?**

A. Yes. Both Mr. Thornton and I agree on this point, which is yet another reason why the Application is in the public interest, consistent with sound financial practice and consistent with the Company's responsibilities as a public service corporation. (*See* Testimony of John S. Thornton, Jr., at page 13, lines 16-22.) Thus, there is no reason to believe that the proposed financing will leave APS in an overly leveraged position.

**Q. DOES APS HAVE LARGE NEEDS FOR ADDITIONAL DEBT CAPITAL FOR ITS DISTRIBUTION AND TRANSMISSION SYSTEMS, WHICH NEEDS WILL COMPETE IN SOME FASHION WITH ISSUANCE OF THE RECAPITALIZATION DEBT?**

A. No. Mr. Thornton expresses this concern at several parts of his testimony. (*See* Testimony of John S. Thornton, Jr., at page 1, lines 22-24; page 4, lines 11-12; and page 5, lines 22-26.) But in fact, APS can finance its distribution and transmission capital budgets, as well as the APS generation capital budget, entirely from internally generated funds during the expected four-year term of the PWEC note. The Company does have to refinance significant amounts of its existing debt in the future, but again that does not require incrementally increased debt levels during this period.

**Q. ARE THERE OTHER ADVANTAGES TO APS FROM THE PROPOSED FINANCING THAT ARE NOT IDENTIFIED BY STAFF?**

A. Yes. My Direct Testimony notes that PWEC's continued viability provides a competitive check on the merchant generators. The proposed financing will eliminate the potential for PWEC having to sell the assets presently serving APS and will allow the Commission to consider their ultimate rate treatment in the Company's next general rate case.

### *3. Source of PWCC's and PWEC's Present Financing Problems and Other Specific Staff Criticisms of My Direct Testimony*

**Q. MR. THORNTON STATES THAT PWEC'S SITUATION IS NEITHER UNIQUE NOR ATTRIBUTABLE TO COMMISSION ACTIONS. DO YOU AGREE?**

A. No. PWEC's difficulty in obtaining permanent financing admittedly is not unique under current market conditions, but the circumstances leading to that difficulty are, in this specific instance, quite unique. PWEC would have been capable of doing its own financing at investment-grade rates once divestiture

was completed by year-end 2002. That divestiture of APS generation had been authorized in the 1999 APS Settlement and required by the Electric Competition Rules, and was the event upon which PWEC's credit rating quite literally depended. Thus, as I testified in my Direct Testimony, granting the financing relief requested still leaves APS, PWCC and PWEC worse off than they were before divestiture was stopped, even before imposition of the Staff's proposed conditions.

Mr. Thornton cites a Standard & Poor's (" S&P") Report discussing the problems of merchant generation as support for his belief that the present situation is not unique. (*See* Testimony of John S. Thornton, Jr., at page 3 and at Schedules JST-5 through JST-8.) But as is discussed in Mr. Davis' Rebuttal Testimony, PWEC is not just another merchant generation venture in either its origin or its purpose.

Mr. Thornton also argues that the Bridge Debt could have been repaid from the proceeds paid by APS for the PWEC generating assets if APS had moved to immediately acquire such assets. (*See* Testimony of John S. Thornton, Jr., at page 10, lines 21-22.) This ignores the fact that APS would have had to borrow the funds for that purchase, thus leaving the Company in the same or worse relative financial position as under the Application. That position would, of course, change significantly if the PWEC assets were thereafter included in the Company's rate base, but that too is no different than what APS intends to seek if the Application is granted.

**Q. DID PWCC CHOOSE THE MATURITY OF THE BRIDGE DEBT AS ALLEGED BY MR. THORNTON AT PAGE 10, LINES 22-25 OF HIS TESTIMONY?**

A. Although that is literally true, it ignores the fact that the APS generating assets were to be transferred to PWEC by the end of 2002. It is no mere coincidence that most of the Bridge Debt is scheduled to mature in 2003. As I indicated in my Direct Testimony, since the Bridge Debt would cover assets that were to be owned by an operating subsidiary of PWCC (at the time, PWEC), lenders were only comfortable in lending these large sums to PWCC for a limited period of time.

**Q. ARE PWCC AND PWEC "IMPLICITLY SUBSIDIZED" BY APS AS ALLEGED BY MR. THORNTON AT PAGE 6, LINES 4-10 OF HIS TESTIMONY?**

A. No, and Mr. Thornton provides no specific examples in his testimony. He states that "PWCC and PWEC are already provided a certain amount of credit support from APS through the holding company structure." (Testimony of John S. Thornton, Jr., at page 6, lines 5-6.) In fact, such credit support exists <u>because</u> of the holding company. There are advantages to all members of a consolidated holding company group arising from business diversity, economies of scale and scope, tax benefits, etc. These advantages are not created by any single member of the group, including APS, and then distributed to the others. They result from the synergies of the group itself and are shared by all members of the group.

Mr. Thornton then contends that the financial community knows that PWCC has access to APS cash flows. (*Id.* at lines 7-8.) PWCC does have access to the <u>earnings</u> of APS because as the sole equity investor in and owner of APS, it is entitled to such earnings in the form of dividends. I doubt owners of common stock believe they are being "subsidized," implicitly or otherwise, by receiving lawful dividends on their investment, nor has this Commission ever so found.

Mr. Thornton also claims that PWEC can access these same cash flows. If all he means is that PWCC can use its earnings, part of which consists of APS dividends, in any lawful fashion it chooses, including funding generation to serve APS, that is certainly no indication of "subsidization." As to direct APS assistance to PWEC, this Application is stark proof that the extent of any such assistance is largely a regulatory decision and not one unilaterally made by PWCC.

I also note that the allocation of common costs among the various members of the Pinnacle West organization and the pricing of inter-affiliate transactions have been either specifically approved by this Commission (as part of the Policies & Procedures that accompanied the Company's Code of Conduct under A.A.C. R14-2-1616) or approved by FERC, or by both. Thus, I do not see any basis for the contention that PWCC and PWEC are somehow improperly "subsidized" by APS.

**Q. DID SCHEDULE BMG-3 OF YOUR DIRECT TESTIMONY INDICATE "THAT BORROWING $500,000,000 FROM THE MARKET AND LENDING IT TO PWEC/PWCC IS A 'WASH' TRANSACTION HAVING NO EFFECT ON THE APS' FINANCIAL RATIOS" AS IS STATED BY MR. THORNTON AT PAGE 11, LINES 8-9 OF HIS TESTIMONY?**

A. No. Schedule BMG-3 shows increased financial leverage both in the debt ratio and in the "Funds from Operations" as a percent of total debt even considering the interest from the PWCC/PWEC note as operating income. I further show all credit metrics being affected using a rating agency approach that would not count interest income as operating income or "Funds from Operations." I also explain the differences between the two sets of calculations at pages 21-22 of my Direct Testimony. Thus, I did not state or imply in my Testimony that APS could lend an unlimited amount of money to PWCC/PWEC, or anyone else for

that matter, without impacting its credit metrics to some degree. To use Mr. Thornton's own terminology, this proposed financing is no "'wash' transaction," but such financing is nevertheless a necessary transaction in view of the present financial market combined with the chain of events initiated by Decision No. 65154.

IV. REPONSE TO PANDA/TECO

**Q. MS. ABBOTT APPEARS TO HAVE GREAT CONCERN OVER THE REACTION OF STANDARD AND POOR'S AND FITCH TO THE PROPOSED FINANCING. DO YOU SHARE THAT CONCERN?**

A. No. Standard and Poor's ("S&P") decision on November 4, 2002 to unify the corporate credit rating of APS with that of PWCC did not affect any of the Company's specific credit ratings for secured or unsecured long-term debt nor its short-term commercial paper rating. S&P also specifically indicated that the $500 million loan to PWEC and the additional debt incurred by APS for that purpose did not jeopardize the Company's strong BBB rating:

> Even on a stand-alone basis, APS' financial health remains solidly within the triple-B category even with the addition of $500 million in debt.

(*See* Schedule BMG-1R. Emphasis supplied.)

Fitch rates APS unsecured debt higher than S&P. Its December 4, 2002 announcement did place both APS and PWCC debt securities on "Rating Watch Negative," which indicates that either or both entities could be down-rated within the next six months. But its rationale for its two actions, which is discussed both in the December 4th pronouncement and again on December 17, 2002, are decidedly different. For PWCC, it is clear that refinancing the Bridge Debt is very troubling. Indeed, Fitch comes right out and says that if the

financing Application is denied, it will result in a PWCC downgrade. As to APS, Fitch has cited three factors, the increased leverage, regulatory uncertainty over the outcome of Track B, and regulatory uncertainty over the Company's next general rate case. But Fitch also notes that the increased debt leverage at APS would be, in their opinion, less of a problem if the underlying PWEC assets were moved to APS and included in rates. The two Fitch reports are attached as Schedules BMG-2R and BMG-3R.

**Q. MS. ABBOTT PRESENTS AN "ANALYSIS" THAT INDICATES A HIGHER DEBT COST WHEN MOODY'S DEBT RATINGS ARE REDUCED TO THE SAME AS S&P'S. DO YOU AGREE WITH HER CONCLUSION?**

A. No. Based on her tiny sample of only five selected companies, I could not draw any meaningful conclusions. The mixing of holding companies with operating entities further obscures whatever validity the analysis would otherwise have held even assuming a larger data sample. Ms. Abbott herself concedes that this is at best "anecdotal evidence." (Testimony of Susan Abbott at page 25, line 1.) And one can just as easily construct a sample of companies "proving" precisely the opposite conclusion from that of Ms. Abbott.

For example, Ms. Abbott states "investors demand similar interest over Treasuries when Moody's and S&P rate issuers the same." (Testimony of Susan Abbott at page 25, lines 19-20.) Yet, Dominion Resources (one of the companies in Ms. Abbott's sample) and Constellation Energy are both rated high BBB (Baa1 and BBB+) by Moody's and S&P. But Dominion trades at 165 basis points over Treasuries while Constellation commands some 245 basis points of premium. Duke Capital and Commonwealth Edison also share the same S&P

and Moody's ratings (this time A- and A3), but the former trades at over 250 basis points higher than the latter.

Ms. Abbott further contends that interest spreads are similar "when Moody's rates the issuer the same but S&P . . . rates the issuer lower than Moody's." (Id. at lines 20-22.) Such a relationship exists for both First Energy and, ironically, TECO (Baa2 by Moody's but BBB- by S&P), yet the former's spread is roughly 280 basis points while TECO's is approximately 580 basis points—hardly a "similar" yield spread.

The only conclusions one can legitimately draw from her analysis and the above exercise are: (1) if you hand-pick a small enough sample, it can show virtually anything you want it to show; and (2) investors look at far more than debt ratings in determining the collective risk premium they require for a particular enterprise. On the other hand, it would appear more logical that when there is a split in the ratings as between S&P and Moody's, the market would be conservative and price based on the lower of the two ratings, thus refuting another element of Ms. Abbott's hypothesis.

**Q. MS. ABBOTT ALSO PREDICTS A MOODY'S DOWNGRADE AS A RESULT OF THE FINANCING. HAVE YOU SEEN ANY EVIDENCE TO SUPPORT SUCH A CONCLUSION?**

A. No. I find it most significant that Moody's has been publicly silent on the Application. I am routinely in contact with Moody's, and I feel confident that Moody's will not drop our current ratings as a result of the Commission granting the Application, and our agreeing to the strict conditions imposed by Staff further diminishes an already unlikely event of that kind.

Even Ms. Abbott's analysis shows APS is in the Baa1 range after the $500 million loan. (*See* Testimony of Susan Abbott at page 19, lines 11-13.) As a former Moody's employee, Ms. Abbott should know that Baa1 is, in fact, the Company's principal debt rating from Moody's and not A3, which only applies to the Company's first mortgage bonds. Given that these mortgage bonds are already heavily over-collaterized (*see* S&P Report dated November 4, 2002, which is attached as Schedule BMG-1R) it is highly unlikely that they would be impacted by $500 million of unsecured debt. Moreover, it is possible for the Company to eliminate all of its first mortgage bonds mature by early 2004, and no new secured debt is contemplated prior to that time.

**Q. COULD THERE BE NEGATIVE IMPACTS TO APS IF THE FINANCING IS DENIED?**

A. Yes. I explain these in my Direct Testimony. Ms. Abbott does not refute the real possibility of such negative impacts, which both Staff and RUCO acknowledge. She simply ignores it in her testimony despite the fact that these adverse impacts are far more likely to occur than those hypothesized in her testimony.

**Q. DO THE VARIOUS CONDITIONS RECOMMENDED BY STAFF AND LARGELY AGREED TO BY THE COMPANY MOOT MS. ABBOTT'S CONCERNS THAT THE FINANCING COULD SOMEHOW HURT APS CUSTOMERS?**

A. Yes. They address both the potentially increased risk of the financing itself, turning it into an asset for the benefit of customers, and the remote possibility of the loan directly affecting APS' cost of capital in the manner hypothesized by Ms. Abbott in her testimony.

**Q. MS. ABBOTT CONTENDS THAT REFINANCING THE BRIDGE DEBT AT PWCC IS A POSSIBILITY, ALBEIT AT A COST. DO YOU AGREE?**

A. No. Ms. Abbott cites no proof for these statements at pages 3, line 19 and 4, line 8 of her testimony. They also ignore the fact that one of the goals of myself, Staff witness Thornton, and RUCO are to avoid further down-ratings at PWCC—hardly consistent with Ms. Abbott's "borrow at any cost" alternative. My own experience in marketing the PWCC equity issuance in mid-December clearly indicated to me that PWCC's access to the capital markets on reasonable terms is largely contingent on a favorable ruling by this Commission on the Company's Application.

**Q. MS. ABBOTT ALSO DISAGREES WITH YOUR OBSERVATION THAT THE PPA ASSUMED BY RATING AGENCIES EVALUATING PWEC MIGHT NOT HAVE BEEN AS ATTRACTIVE AS THE ALTERNATIVE OF HAVING THE PWEC ASSETS UNENCUMBERRED IN THE MARKET (TESTIMONY OF SUSAN ABBOTT AT PAGE 28, LINES 6-12.) WHAT IS YOUR RESPONSE?**

A. Both my original observation and Ms. Abbott's beliefs to the contrary are largely irrelevant to the unchallenged fact that PWEC did have an investment-grade credit rating premised on divestiture. But, in point of fact, neither of us will ever know for sure if we are right since there is no way to go back in time and present the alternatives to the rating agencies. I do submit, however, that a three-year PPA priced at cost between APS and PWEC, during a period when the former is under a rate moratorium and has no power cost adjustment mechanism, is not an obviously superior choice for PWEC or certainly PWCC. Faced with such a limited alternative, the unfettered ability of PWEC to sell into the competitive market could well have appeared more attractive than Ms. Abbott postulates in this portion of her testimony.

V. UPDATE FOR EVENTS SINCE MY OCTOBER TESTIMONY

**Q. WHAT EVENTS HAVE OCCURRED SINCE THE FILING OF YOUR OCTOBER TESTIMONY THAT YOU BELIEVE ARE RELEVANT TO THE COMMISSION'S CONSIDERATION OF THE APPLICATION?**

A. I have already discussed the S&P and Fitch actions to some extent. The other actions of significance are the Commission's granting of the Company's Emergency Application in Docket No. E-01345A-02-0840, the filing of Staff's Recommendation in this Docket, which was concurrent with the execution of the Principles for Resolution ("Principles") of Track A issues between Staff and the Company, the cancellation of Redhawk Units 3 and 4, and a new common equity issuance by PWCC.

**Q. WHAT WAS THE FINANCIAL MARKET REACTION TO THE COMMISSION'S GRANTING OF THE EMERGENCY APPLICATION FOR APS TO LEND UP TO $125 MILLION TO PWCC?**

A. It was extremely positive. Goldman Sachs, Gerard Klauer Mattison, Merrill Lynch and others all viewed it as good news, although it is clear they are also expecting positive action by the Commission on the Company's Application in this Docket and are obviously anxious about several issues in the upcoming APS rate case.

**Q. DOES THAT TRANSACTION AFFECT THE PRESENT REQUEST FOR AUTHORITY TO BORROW AND LEND $500 MILLION?**

A. The $125 million credit line from APS to PWCC does not reduce, either qualitatively or quantitatively, the need for the longer-term $500 million loan. However, to the extent that Decision No. 65434 relieved the market's liquidity concerns about PWCC, it may have made an APS loan to PWCC better received in the market.

**Q. WHAT ABOUT STAFF'S RECOMMENDATION IN THIS CASE?**

A. There was also a positive reaction to the overall recommendation. The conditions proposed by Staff received mixed reviews. Deutsche Bank indicated that they "seemed reasonable," while Lehman Brothers called them a "low water mark." Others merely noted that the conditions seemed acceptable to APS and thus should not be considered "deal killers."

**Q. WHAT ABOUT THE OTHER ACTIONS YOU HAVE CITED?**

A. The common equity issuance and the cancellation of the two Redhawk units were also deemed a plus. The Principles although noted, did not elicit any particularly substantive comments.

## VI. CONCLUSION

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

A. APS is appreciative of the support it has received from both Staff and RUCO. Because they represent to one extent or another, APS customers in addition to the public, their conclusion that the Application should be granted, albeit with strict conditions, is especially meaningful. APS would ask that the Commission clarify the calculation of equity ratio under Condition No. 7 as discussed herein. The Commission should also modify Condition No. 3 to more properly and, just as importantly, equitably reflect the additional premium APS will collect from PWEC on account of this loan. That premium is no more than 150 basis points over a comparable secured borrowing by APS. Finally, my Rebuttal Testimony has addressed the concerns raised by both Staff witness Thornton and Panda/TECO witness Abbott. I urge the Commission to act promptly and grant

the Company's Application as requested subject to the conditions proposed by Staff.

**Q. DOES THAT CONCLUDE YOUR PREFILED REBUTTAL TESTIMONY IN THIS PROCEEDING?**

A. Yes, it does.

# EXHIBIT

# BMG – 1R

STANDARD &POOR'S | RATINGSDIRECT

Return to Regular Format

# Research:

## Arizona Public Service Co.'s Corporate Credit Rating Lowered; Parent Pinnacle Affirmed

**Publication date:** 04-Nov-2002
**Credit Analyst:** Kathryn Mock Masterson, San Francisco (1) 415-371-5009

NEW YORK (Standard & Poor's) Nov. 4, 2002--Standard & Poor's Ratings Services said today it affirmed the debt securities ratings of electric utility Arizona Public Service Co. (APS) and lowered the corporate credit rating (CCR) to triple-'B' from triple-'B'-plus. At the same time, it affirmed the triple-'B' corporate credit rating of parent Pinnacle West Capital Corp. (PWCC), and lowered its triple-'B' senior unsecured debt rating to triple-'B'-minus.

The downgrade of the APS CCR is the result of Standard and Poor's conclusion that the regulatory insulation standard is insufficient to warrant a separation of the CCRs between APS and PWCC. The triple-'B' CCR at both entities reflects the consolidated rating of the combined entity.

"This action also results in a change in the unsecured debt rating at PWCC because of the structural subordination of this debt as compared to the unsecured debt at APS since the two are viewed as a single economic entity," said Standard & Poor's credit analyst Kathryn Mock Masterson.

The senior secured rating of APS was affirmed at senior secured 'A-' due to substantial overcollateralization of the first mortgage bonds and, importantly, management's stated intent not to issue significant additional secured debt. All first mortgage bonds are callable as of March 2004, which will allow APS to retire its old 1946 master first mortgage bond indenture.

It is important to note that these rating actions are not a result of the company's proposal to move $500 million of debt from PWCC to APS. Based on Standard & Poor's consolidated rating methodology, the movement of debt from the parent to the subsidiary does not affect the overall financial health of the entities. Even on a stand-alone basis, APS' financial health remains solidly within the triple-'B' category even with the addition of $500 million in debt.

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www2.standardandpoors.com; under Fixed Income in the left navigation bar, select Credit Ratings Actions.

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# EXHIBIT

# BMG – 2R

FitchRatings

Fitch : Info Center Press Release

## Fitch Ratings Places PNW & APS On Rating Watch Negative Ratings

04 Dec 2002 3:00 PM

Fitch Ratings-New York-December 4, 2002: Fitch Ratings has placed the debt ratings of Pinnacle West Capital Corp. (PNW) and its operating utility subsidiary, Arizona Public Service Company (APS) on Rating Watch Negative. The Rating Watch affects PNW's 'BBB' senior unsecured debt 'F2' commercial paper ratings, APS's 'A-' senior secured and 'BBB+' senior unsecured debt ratings. APS's 'F2' Commercial Paper rating is affirmed by Fitch.

The Rating Watch Negative for PNW reflects concern over the company's ability to refinance $790 million of maturing debt issued to finance power plant development at its independent power subsidiary, Pinnacle West Energy Company (PWEC), increasing exposure to merchant energy markets, and the uncertain regulatory treatment of 1,800 mw of new generation. The Negative Rating Watch for APS reflects regulatory uncertainty and the potential increase in leverage related to PNW's plan to issue debt at APS. APS recently received approval to provide a $125 million line of credit to PNW, and has requested Arizona Corporation Commission (ACC) approval to issue $500 million of unsecured debt (or to guarantee a similar amount) with the intent to use the proceeds to pay down maturing PNW debt. The incremental debt would be less problematic if it ultimately becomes part of the cost of transferring and rate-basing PWEC's generation at APS.

PNW's original plan to issue debt at PWEC is no longer possible due to the ACC's decision to block the transfer of APS' generating capacity to PWEC. Also affecting PNW's refinancing plan are depressed wholesale power markets, a restrictive capital market environment, and PWEC's relatively small generation portfolio (1,300 mWs in operation). The planned asset transfer was in accordance with the ACC-approved electric industry restructuring settlement. The ACC's decision in Track A of its generic review of electric competition blocked the transfer of the generation assets from APS to PWEC, and was silent on the status of 1,800 mWs of unregulated generation capacity built by PWEC to meet APS demand growth.

With PWEC unable to fund itself, PNW is relying on the utility to refinance the majority of the $790 million of bridge financing debt maturing over the next 14 months through an inter-company loan. If an inter-company loan is authorized by the ACC, the proceeds will be transferred to PNW and used to reduce parent-company debt. It is unclear whether the ACC will approve the company's $500 million financing request. Failure to obtain the inter-company loan or access alternate sources of funding would result in a downgrade of PNW.

Contact: Philip Smyth 1-212-908-0531 or Robert Hornick 1-212-908-0523, New York.

Media Relations: Matt Burkhard 1-212-908-0540, New York.

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# EXHIBIT

# BMG – 3R

FitchRatings

Fitch : Info Center : Press Release

## Fitch Comments On Staff Testimony In APS Financing Request Ratings

17 Dec 2002 2:05 PM

Fitch Ratings-New York-December 17, 2002: Recent testimony filed by the staff of the Arizona Corporation Commission (ACC) supporting Arizona Public Service Company's (APS) requested financing order is positive for the credit quality of Pinnacle West Capital Corp. (PNW), according to Fitch Ratings. The financing order seeks authority to issue $500 million of unsecured debt. Proceeds would be used to refinance maturing parent company debt incurred to fund power plant development at its non-regulated subsidiary Pinnacle West Energy Corp. (PWEC). If ultimately approved by the ACC, the financing would provide sufficient liquidity for PNW to meet debt maturities in 2003. In combination with the 'Principles of Resolution' agreed to by the Staff and APS (and discussed below), the staff testimony also lends some clarity to the regulatory process in Arizona and signals a reasonable working environment with the ACC Staff. Fitch recently placed the 'BBB' senior unsecured debt ratings of PNW on Rating Watch Negative citing concern over the company's ability to refinance $790 million of maturing over the next 14 months, increasing exposure to merchant energy markets, and the uncertain regulatory treatment of 1,800 mw of new generation. The Rating Watch Negative at PNW could be resolved favorably if the financing order were approved by the ACC in combination with a demonstration by the company of access to capital markets at reasonable rates. The transfer of PWEC capacity to APS and its inclusion in rates would also be favorable.

The impact of the staff recommendation on APS' ratings (listed below) will depend on the ultimate treatment of the 1,800 mw of capacity currently owned by PWEC. The current Negative Rating Watch for APS reflects the potential increase in leverage related to PNW's plan to issue debt at APS and regulatory uncertainty over the company's upcoming rate case and the process for securing future power supply. In revising the Rating Watch for APS to Negative from Stable on Dec. 4, 2002, Fitch noted that increased utility debt would be less of a concern if it is part of the cost of acquiring and ultimately rate basing the 1,800 mWs of PWEC generating capacity.

On Friday, Dec. 13, 2002, the ACC Staff filed testimony supporting APS's request for authorization to issue $500 million of unsecured debt, with the intent to use the proceeds to repay maturing PNW debt. Separately, the Staff and APS have agreed to principles for resolving certain issues raised by APS in its appeal of the Commission's Track A order. Under the resolution, APS would limit any prospective Track A appeal to the following issues, which would be appropriate for consideration by the commission in the company's 2003 base rate case: 1) the inclusion of 1,800 mWs of generation constructed by PWEC to meet APS demand growth; 2) the appropriate treatment of $234 million of pre-tax asset write-off agreed to by APS as part of the 1999 settlement agreement; and 3) the appropriate treatment for costs incurred by APS in preparation for the transfer of generation assets to PWEC.

PNW's original plan to issue debt at PWEC is no longer possible due to the ACC's decision to block the transfer of APS' generating capacity to PWEC. Also affecting PNW's refinancing plan are depressed wholesale power markets, a restrictive capital market environment, and PWEC's relatively small generation portfolio (1,300 mWs in operation). The planned asset transfer was in accordance with the ACC-approved electric industry restructuring settlement. The ACC's decision in Track A of its generic review of electric competition blocked the transfer of the generation assets from APS to PWEC, and was silent on the status of 1,800 mWs of unregulated generation capacity built by PWEC to meet APS demand growth.

Pinnacle West Capital's ratings are as follows:

--Senior unsecured 'BBB'; and,

--Commercial paper 'F2'.

## Pinnacle West Capital Corp.

Philip W. Smyth, CFA
1 212 908-0531
philip.smyth@fitchratings.com

| Senior Secured | Senior Unsecured | Short-Term | Watch | Last Reviewed |
|---|---|---|---|---|
| - | BBB | F2 | Negative | 12/02 |

## Arizona Public Service Co.

Philip W. Smyth, CFA
1 212 908-0531
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| Senior Secured | Senior Unsecured | Short-Term | Watch | Last Reviewed |
|---|---|---|---|---|
| A- | BBB+ | F2 | Negative | 12/02 |

### Outlook

The Rating Watch Negative status for PNW reflects concern regarding the company's ability to refinance $790 million of maturing debt issued by the parent to finance power plant development at Pinnacle West Energy Corp. (PWEC). Recent testimony filed by the staff of the Arizona Corporation Commission (ACC) supporting Arizona Public Service Company's (APS's) requested financing order could resolve the refinancing risk at PNW. The financing order seeks authority to issue $500 million of unsecured debt. Proceeds would be used to refinance maturing parent company debt incurred to fund power plant development at PNW's non-regulated subsidiary, PWEC. If ultimately approved by the ACC, the financing would provide sufficient liquidity for PNW to meet debt maturities in 2003..

At APS, the Rating Watch Negative status is due to regulatory uncertainty and the potential increase in leverage related to PNW's plan to issue debt at APS to refund maturing bridge-debt at the parent. The impact of the financing order on APS, if it is approved by the ACC, will depend on the treatment of 1,800 MWs of PWEC generating plant. The incremental APS debt would be less problematic if it ultimately becomes part of the cost of transferring and rate-basing PWEC generation at the utility. The support of the Arizona Corporation Commission (ACC) staff for APS's recent financing order along with an agreement between APS and staff regarding Track A issues appropriate for commission consideration lends some clarity to the regulatory process in Arizona and signals a reasonable working environment with the ACC staff.

### What could lead to positive rating action?

- For PNW, successful execution of $500 million inter-company loan in combination with a demonstration by the company of access to capital markets at reasonable rates.
- Alternatively, success of contingency plans to meet refinancing needs.
- For APS, ability to rate base PWEC generation to offset potential increase in debt.

### What could lead to negative rating action?

- Inability of PNW to access capital markets in early-2003.
- Exclusion of PWEC capacity from utility rate base, combined with continued poor merchant market fundamentals.
- Major unscheduled nuclear outage or nuclear accident at Palo Verde.

**Gross Debt at Sept. 30, 2002:**

| | |
|---|---|
| PNW (Group): | $3,863mil. |
| PNW (Parent level): | $1,073mil. |
| APS: | $2,632mil. |

**Off-Balance Sheet Debt* at Sept. 30, 2002:**

| | |
|---|---|
| PNW (Group): | c. $406mil. |

**Available Liquidity* at Sept. 30 2002:**

| | | |
|---|---|---|
| PNW: | | c.$278mil. |
| | Including cash of | $28mil. |
| APS: | | c.$259mil. |
| | Including cash of | $9mil. |

**Credit Facilities Expiring in 2003:**

| | |
|---|---|
| PNW: | $125mil. (12/03) |
| APS: | $250mil. (6/03) |

**Debt Maturing in 2003:**

| | | |
|---|---|---|
| PNW: | Bridge loan | $300mil. (7/03) |
| | | $250mil. (8/03) |
| | | $25mil. (12/03) |
| APS: | | Nil during 2003 |

* Fitch calculations.

Rating action: change in Outlook, instigation of a Rating Watch or change in rating level. Revision of an Outlook from Negative to Stable, or removal from Rating Watch and instigation of a Stable Outlook would constitute positive rating action. Off-balance sheet includes leasing agreements, tolling agreements, prepayment contracts, guarantees and similar undertaking. More details can be obtained from the analyst named above.

EXHIBIT
APS-3
Admitted

# 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 Capitalization | 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 MARKETS 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.

EXHIBIT
APS-4
Admitted

# REBUTTAL TESTIMONY OF ARTHUR H. TILDESLEY

Managing Director, Salomon Smith Barney Inc.

On Behalf of Arizona Public Service Company

Docket No. E-01345A-02-0707

December 30, 2002

# REBUTTAL TESTIMONY OF ARTHUR H. TILDESLEY

ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY

(Docket No. E-01345A-02-0707)

## INTRODUCTION

**Q. Please state your name, occupation, and business address.**

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. Have you previously submitted written direct testimony in this proceeding?**

A. Yes.

**Q. What is the purpose of your rebuttal testimony?**

A. The purpose of my testimony is to address certain points in Staff witness John S. Thornton, Jr.'s testimony, filed on December 13, 2002. More specifically, I will respond to:

- his conclusion that the potential weakening in Arizona Public Service Company's (APS) financial ratios resulting from the issuance of an additional $500 million of debt is significant and would negatively impact the Company;
- his statement that my conclusions on the limited ability of Pinnacle West Energy Corporation (PWEC) to access financing are "speculative and unsupported by documentation;" and
- his assertion that my conclusions regarding the impact of PWEC market access on Pinnacle West Capital Corporation (PWCC) credit quality are "speculative and unsupported by documentation."

## SUMMARY OF CONCLUSIONS

**Q. Briefly summarize your rebuttal.**

A. The conclusions in my testimony were backed by significant and credible evidence at the time of its filing and my testimony filed on October 11, 2002, is still valid in every respect. I also have obtained and provide further evidence from the period after October 11, 2002 to support my initial conclusions.

## COMMENT ON THE TESTIMONY OF MR. THORNTON

**Q. In your testimony filed on October 11, 2002, you state that you believe that a $500 million intercompany loan from APS to PWEC will not impair fundamental utility credit quality. Are you still of the same opinion?**

A. Yes, I am. As I stated in my testimony filed on October 11, 2002, our own financial analysis indicates that APS business fundamentals and credit statistics are quite strong, and that APS has sufficient credit capacity to provide an intercompany loan to PWEC in the amount of $500 million without impairing fundamental utility credit quality. This conclusion was based on our analysis showing that APS' credit statistics pro forma for a $500 million loan would remain within the ranges specified by S&P for a BBB rating. (Please see pp. 8-10 of my October 11, 2002 direct testimony.) Rating agencies establish such ranges and use them as only one of several factors in assessing a company's credit rating. Other factors that are taken into consideration include, but are not limited to, the quality of regulation, the quality of management and the company's competitive position. The rating agencies have made it clear that the rating process takes into account a broad analysis of business and financial risk, and that no single factor, including financial ratios, can be used to exclusively determine a credit rating.

**Q. In his testimony, Mr. Thornton states that he disagrees with your conclusion regarding the impact on APS, and that "the potential reduction in APS' financial ratios is significant and would negatively impact the Company." What is your response?**

A. In addition to the analysis referred to in the previous question, I would refer to a report released by Standard & Poor's (S&P) after I filed my original testimony on October 11, 2002. This report directly supports the view I expressed in my testimony on the potential impact on the credit quality of APS.

On November 4, 2002 S&P released a report on APS that stated:

> Based on Standard & Poor's consolidated rating methodology, the movement of debt from the parent to the subsidiary does not affect the overall financial health of the entities. *Even on a stand-alone basis, APS' financial health remains solidly within the 'BBB' category even with the addition of $500 million in debt.* ... Liquidity [at the consolidated entity] is adequate, but will fall to slim levels in mid-2003 when the $550 million comes due. The company intends to redeem this debt with the $500 million issue at APS, which will be loaned to PWEC to repay most of the financing. Dividends from APS and SunCor in 2003 and 2004 are expected to be sufficient to repay the remaining amounts. *The current ratings reflect the assumption that this repayment will occur and that the $500 million will be issued at APS. The stable outlook reflects the assumption that the ACC will approve the application by PWCC to issue up to $500 million at APS* to repay a portion of the $750 million bridge financing at PWCC that was done to build assets at PWEC, as required by the 1999 settlement agreement with the ACC.
>
> S&P Summary Analysis – Arizona Public Service Co., November 4, 2002 (*italics* added for emphasis)

**Q. In your original testimony, you state that "PWEC does not have access to third-party debt financing on a non-recourse basis in any meaningful amount." Mr. Thornton calls your statement "speculative and unsupported by documentation." How do you respond?**

A. In 2003, PWEC will operate as a pure merchant generating company, meaning they have no long-term contracts for the sale of output or capacity from their generating facilities. I stated in my initial testimony that there have been no pure merchant financings in either the bank or bond markets since the fourth quarter of 2001, and this still remains true. Investors are unwilling to lend capital against merchant generation assets due to concerns over low wholesale power prices. The statement from S&P quoted in my initial testimony still holds true:

> 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)

Furthermore, I would like to point to a recent report from Fitch Ratings (Fitch), which was released on December 17, 2002, in response to the filing of testimony by the staff of the ACC. In this report, Fitch writes:

> "*PNW's original plan to issue debt at PWEC is no longer possible due to the ACC's decision to block the transfer of APS' generating capacity to PWEC.* Also affecting PNW's refinancing plan are depressed wholesale power markets, a restrictive capital market environment, and PWEC's relatively small generation portfolio (1,300 MWs in operation)."
>
> Fitch Ratings Comments on Staff Testimony in APS Financing Request, December 17, 2002 (*italics* added for emphasis)

**Q. Has Mr. Thornton offered any evidence of his own that PWEC could currently access capital markets in any meaningful fashion?**

**A.** No.

**Q. Has there been any change in the financial markets since you filed your original testimony that would make you reconsider your statement regarding the lack of access to the capital markets for PWEC on a standalone basis?**

A. No, there has not. There have been no new financings in the bank or public bond markets of pure merchant generating assets since I filed my original testimony. In addition, the outstanding debt of the companies whose business is predominantly merchant generation continues to trade at credit spreads indicating that new issuance would not be possible.

**Q. In his testimony, Mr. Thornton points out that your statement regarding the lack of access to the capital markets for PWEC on a standalone basis "was not supported by any documentation of PWEC efforts to raise significant debt financing." Is it "speculative" to come to a conclusion on this topic without actually having tried to raise financing at PWEC?**

A. No, it is not. An important part of the work we do at Salomon Smith Barney is related to assessing the feasibility of potential financing transactions and the rate at which we believe any financing will price once it is launched. This work is performed routinely throughout our institution and for a wide variety of clients and types of financings. We are the largest underwriter of debt securities in the world having raised over $429 billion in 2001, and more specifically, we are the largest underwriter of investment grade debt securities in the U.S. power sector, raising nearly $15 billion in 2001. We also consistently rank as the number one or two arranger of syndicated bank loans to the U.S. power sector. As such, we are well-positioned to be able to evaluate the market appetite for different issuers and types of securities.

In addition, prospective borrowers do not normally test the credit markets to find out whether they can borrow funds on commercially reasonable terms. The cost of a failed issuance can be extremely high in terms of future financial credibility, and prudent borrowers do not attempt to secure financing unless there is a high probability of success.

**Q. In your original testimony you conclude that the credit quality of PWCC might suffer if PWEC is not able to obtain new debt financing on a standalone or non-recourse basis. In his testimony Mr. Thornton calls this statement "speculative and unsupported by documentation." What is your response to Mr. Thornton's comments?**

A. As I stated in my original testimony, I believe that the inability of PWEC to fund on a standalone or non-recourse basis in the bank loan or public debt markets may have

adverse credit consequences for PWCC. This view was supported among other things by the following statement from Moody's:

> 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.*
>
> Moody's Opinion Update on PWCC, September 9, 2002 (*italics* added for emphasis)

**Q. Does this conclude your written rebuttal testimony in this proceeding?**

A. Yes, it does.

Moody's Investors Service

Global Credit Research
Opinion Update
30 DEC 2002

**Opinion Update:** Pinnacle West Capital Corporation

EXHIBIT APS-5 Accepted

**Pinnacle West Capital Corporation**

*United States*

**Ratings**

| Category | Moody's Rating |
|---|---|
| Issuer Rating | Baa2 |
| Senior Unsecured | Baa2 |
| Subordinate Shelf | (P)Baa3 |
| Preferred Shelf | (P)Ba1 |
| Commercial Paper | P-2 |
| **Arizona Public Service Company** | |
| Issuer Rating | Baa1 |
| First Mortgage Bonds | A3 |
| Senior Secured | A3 |
| Senior Unsecured | Baa1 |
| Subordinate Shelf | (P)Baa2 |
| Commercial Paper | P-2 |

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| Mo Ying W. Seto/New York | |
| Daniel Gates/New York | |

**Opinion**

**Rating Rationale**

The Baa2 senior unsecured rating of Pinnacle West Capital Corporation (PWCC) reflects the strength of its principal subsidiary, Arizona Public Service Company (APS: Senior Unsecured Debt at Baa1), its growing service territory, the utility's predictable cash flow, and a conservative dividend payout ratio. The rating factors in the level of structural subordination that exists relative to subsidiary debt.

PWCC faces refinancing risk, particularly in 2003, when approximately $500 million of holding company debt is due. ACC approval of the below outlined financing application should help to address this refinancing concern at the parent.

**Recent Developments**

On 12/13/02, the Arizona Corporation Commission staff (ACC staff) recommended approval of the APS financing application including the ability of APS to lend Pinnacle West Energy (PWE) up to $500 million under predefined terms. These terms include, among other things, that the loan be secured by PWE assets, and that APS maintain a common equity ratio of at least 40%. ACC hearings will begin in January 2003.

Also, on 12/13/02 the ACC staff and APS agreed in a separate document that it would be appropriate for the ACC to consider in APS' upcoming general rate case whether certain power plants currently owned by PWE should be included in APS' rate base.

On 12/23/02, PWCC raised approximately $200 million in net proceeds from the sale of common stock. The proceeds were used for debt reduction at PWCC.

**Rating Outlook - Stable**

PWCC's rating outlook is stable and incorporates the view that the ACC will adopt the staff recommendation concerning the APS financing application, which should allow for a successful refinancing of PWCC debt.

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Moody's Investors Service

Global Credit Research
Opinion Update
30 DEC 2002

**Opinion Update:** Arizona Public Service Company

**Arizona Public Service Company**

*Phoenix, Arizona, United States*

**Ratings**

| Category | Moody's Rating |
|---|---|
| Issuer Rating | Baa1 |
| First Mortgage Bonds | A3 |
| Senior Secured | A3 |
| Senior Unsecured | Baa1 |
| Subordinate Shelf | (P)Baa2 |
| Commercial Paper | P-2 |
| **Parent: Pinnacle West Capital Corporation** | |
| Issuer Rating | Baa2 |
| Senior Unsecured | Baa2 |
| Subordinate Shelf | (P)Baa3 |
| Preferred Shelf | (P)Ba1 |
| Commercial Paper | P-2 |

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| Daniel Gates/New York | |


**Opinion**

**Rating Rationale**

Arizona Public Service Company's (APS) senior secured debt rating of A3 and its senior unsecured debt rating of Baa1 reflects strong cash flows, a robust service territory, a low number of industrial customers, and modest leverage. The rating also recognizes the historically less predictable regulatory environment in Arizona but also notes APS's ability to effectively operate against this backdrop. Moody's considers APS's senior unsecured rating to be the company's reference rating since nearly 80% of APS's total debt is senior unsecured debt and first mortgage debt continues to decline as a component of the company's capital structure.

**Recent Developments**

On 12/13/02, the Arizona Corporation Commission staff (ACC staff) recommended approval of the APS financing application including the ability of APS to lend Pinnacle West Energy (PWE) up to $500 million under predefined terms. These terms include, among other things, that the loan be secured by PWE assets, and that APS maintain a common equity ratio of at least 40%. ACC hearings will begin in 01/03. The ACC staff and APS also agreed in a separate document that it would be appropriate for the ACC to consider in APS' upcoming rate case whether certain power plants currently owned by PWE should be included in APS' rate base.

On 12/23/02, APS' parent, Pinnacle West Capital Corp. (PWCC) raised about $200 million in net proceeds from the sale of common stock. Proceeds were used for debt reduction at PWCC.

**Rating Outlook - Stable**

APS's rating outlook is stable and incorporates the view that the ACC will adopt the staff recommendation concerning the APS financing application and other Track A issues. Moody's notes that while APS' coverages may decline if the financing application is approved, the resulting credit metrics should remain consistent with the current rating, particularly when one considers the benefits to bondholders of having APS remain vertically integrated.

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Moody's Investors Service

Global Credit Research
Opinion Update
9 SEP 2002

Opinion Update: Pinnacle West Capital Corporation

EXHIBIT
AS-6
Marked

# Pinnacle West Capital Corporation

*United States*

## Ratings

| Category | Moody's Rating |
|---|---|
| Issuer Rating | Baa2 |
| Senior Unsecured | Baa2 |
| Subordinate Shelf | (P)Baa3 |
| Commercial Paper | P-2 |
| **Pinnacle West Energy Company** | |
| Issuer Rating | Baa2 |
| **Arizona Public Service Company** | |
| Issuer Rating | Baa1 |
| First Mortgage Bonds | A3 |
| Senior Secured | A3 |
| Senior Unsecured | Baa1 |
| Subordinate Shelf | (P)Baa2 |
| Commercial Paper | P-2 |

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|---|---|
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| Mo Ying W. Seto/New York | |
| Daniel Gates/New York | |


## Opinion

### Rating Rationale

The Baa2 senior unsecured rating of Pinnacle West Capital Corporation (Pinnacle) reflects the strength of its principal subsidiary, Arizona Public Service Company (APS: Sr. Sec. at A3), its growing service territory, the utility's predictable cash flow, and a conservative dividend payout ratio. The rating factors in the level of structural subordination that exists relative to subsidiary debt.

The rating considers the growth strategy of Pinnacle's non-regulated generation business, which is focused on owning generation assets in the Southwest. The company plans to build about 2,600 mws of natural gas fired generating assets by 2006 of which $800-$900

million has already been debt financed at Pinnacle.

**Recent Developments**

In August 2002, the Arizona Corporation Commission (ACC) reversed its requirement that Arizona utilities divest their generating assets as part of its electric restructuring plan. Although the ACC provides for a future process to consider the impact of generating assets built or under construction between 1999 and 2003, the decision makes recovery of the costs of these plants dependent on a future bidding process for new loads which will be defined in a pending procedure.

The ACC also determined that if, as a result of this decision, APS wishes to acquire certain generation assets from affiliate Pinnacle West Energy, APS should file an appropriate application for ACC consideration.

APS believes that the order modifies the company's 1999 settlement without sufficient consideration of the impact of such action or recognition of plants built since 1999 to serve the needs of APS retail customers. As a result, APS plans to file a motion for reconsideration.

**Rating Outlook**

The rating outlook 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.

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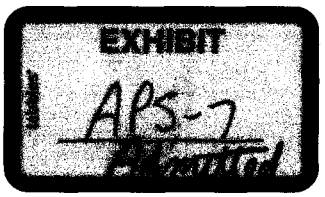


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**(VARIABLE RATE)**

**THIS DEED OF TRUST SECURES VARIABLE RATE PROMISSORY NOTES.**

THIS DEED OF TRUST AND FIXTURE FILING (With Assignment of Rents and Security Agreement) (as it may be amended and modified from time to time, the "Deed of Trust") is made as of December 4, 2002, by and among **PINNACLE WEST ENERGY CORPORATION, an Arizona corporation ("Trustor")**, whose mailing address is 400 North 5th Street, Phoenix, Arizona 85004, **FIRST AMERICAN TITLE INSURANCE COMPANY, a California corporation ("Trustee")**, whose mailing address is P.O. Box 2922, Phoenix, Arizona, and **ARIZONA PUBLIC SERVICE COMPANY, an Arizona corporation, ("Beneficiary")**, whose mailing address is 400 North 5th Street, Phoenix, Arizona 85004. Capitalized terms used in this Deed of Trust not otherwise defined herein shall be as used in that certain 364-Day Credit Agreement, dated of even date herewith, by and between Beneficiary, as Lender and PINNACLE WEST CAPITAL CORPORATION, an Arizona corporation, as "Borrower" (the "Loan Agreement").

FOR GOOD AND VALUABLE CONSIDERATION, including the indebtedness herein recited and the trust herein created, the receipt of which is hereby acknowledged, Trustor hereby irrevocably grants, transfers, conveys and assigns to Trustee, IN TRUST, WITH POWER OF SALE, for the benefit and security of Beneficiary, under and subject to the terms and conditions hereinafter set forth, that certain real property located in the County of Maricopa, State of Arizona, more particularly described in Exhibit A attached hereto and incorporated herein by this reference (the "Premises");

TOGETHER WITH any and all buildings and other improvements now or hereafter erected on the Premises including, without limitation, fixtures, attachments, appliances, equipment, machinery, and other personal property attached to such buildings and other improvements (the "Improvements"), all of which shall be deemed and construed to be a part of the real property;

TOGETHER WITH all rents, issues, profits, damages, royalties, income and other benefits now or hereafter derived from the Premises and the Improvements (collectively the "Rents"), subject to the terms and provisions of Article II of this Deed of Trust with respect to all leases and subleases of the Premises or Improvements now or hereafter existing or entered into,

or portions thereof, granted by Trustor, and further subject to the right, power and authority hereinafter given to Trustor to collect and apply such Rents;

TOGETHER WITH all interests, estates or other claims, both in law and in equity, which Trustor now has or may hereafter acquire in the Premises or the Improvements;

TOGETHER WITH all easements, rights-of-way and other rights now owned or hereafter acquired by Trustor used in connection with the Premises or the Improvements or as a means of access thereto (including, without limitation, all rights pursuant to any trackage agreement and all rights to the nonexclusive use of common drive entries, and all tenements, hereditaments and appurtenances thereof and thereto) and all water and water rights and shares of stock evidencing the same;

TOGETHER WITH all leasehold estate, right, title and interest of Trustor in and to all leases or subleases covering the Premises or the Improvements or any portion thereof now or hereafter existing or entered into, and all right, title and interest of Trustor thereunder including, without limitation, all rights of Trustor against guarantors thereof, all cash or security deposits, advance rentals, and deposits or payments of similar nature (collectively, the "Leases");

TOGETHER WITH all right, title and interest now owned or hereafter acquired by Trustor in and to any greater estate in the Premises or the Improvements;

TOGETHER WITH all right, title, and interest of Trustor in (i) the property and interests in property described on Exhibit B attached hereto and incorporated herein by reference, and (ii) all proceeds thereof (such personal property and proceeds are referred to herein collectively as the "Personal Property");

TOGETHER WITH all right, title and interest of Trustor, now owned or hereafter acquired, in and to any land lying within the right-of-way of any street, open or proposed, adjoining the Premises, and any and all sidewalks, alleys and strips and gores of land adjacent to or used in connection with the Premises;

TOGETHER WITH all the estate, interest, right, title, other claim or demand, both in law and in equity (including, without limitation, claims or demands with respect to the proceeds of insurance in effect with respect thereto) that Trustor now has or may hereafter acquire in the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate (as defined below), and any and all awards made for the taking by eminent domain, or by any proceeding of purchase in lieu thereof, of the whole or any part of the Trust Estate (including, without limitation, any awards resulting from a change of grade of streets and awards for severance damages);

TOGETHER WITH all proceeds of the foregoing.

The entire estate, property, right, title and interest hereby conveyed to Trustee may hereafter be collectively referred to as the "Trust Estate."

FOR THE PURPOSE OF SECURING (in such order of priority as Beneficiary may elect) the following (the "Obligations"):

(a) all obligations of Borrower to Beneficiary pursuant to the Loan Agreement in the maximum principal amount of **ONE HUNDRED TWENTY-FIVE MILLION AND NO/100 DOLLARS ($125,000,000.00)**, as more particularly evidenced by the Notes (the Loan Agreement contains a provision providing for a variable rate of interest under the Notes); and

(b) payment of all sums advanced by Beneficiary to protect the Trust Estate, with interest thereon equal to the Base Rate plus three percent (3%);

(c) performance of every obligation of Borrower and/or Trustor contained in the Financing Documents (as defined below);

(d) performance of every obligation of Trustor contained in any agreement, document, or instrument now or hereafter executed by Trustor reciting that the obligations thereunder are secured by this Deed of Trust; and

(e) for the benefit of Beneficiary, compliance with and performance of each and every provision of any declaration of covenants, conditions and restrictions, any maintenance, easement and party wall agreement, or any other agreement, document, or instrument by which the Trust Estate is bound or may be affected.

This Deed of Trust, the Notes, the Loan Agreement, and any other deeds of trust, mortgages, agreements, guaranties or other instruments given to evidence or further secure the payment and performance of any or all of the Obligations, as the foregoing may be amended, modified, extended, or renewed from time to time may hereinafter be collectively referred to as the "Financing Documents."

TRUSTOR HEREBY COVENANTS AND AGREES AS FOLLOWS:

## ARTICLE I
## COVENANTS AND AGREEMENTS OF TRUSTOR

1.01 Maintenance, Repair, Alterations. Trustor shall keep the Trust Estate in good condition and repair. Trustor shall not remove, demolish, or substantially alter any of the Improvements, except with the prior written consent of Beneficiary; provided, however, that the written consent of Beneficiary shall not be required for any removal, demolition or alterations to the Improvements resulting from Trustor's ongoing construction program or in connection with Trustor's Prudent Utility Practices. For purposes of this Deed of Trust, "Prudent Utility Practices" shall mean those nationally recognized practices, methods, standards and acts (including, but not limited to, the practices, methods, standards and acts engaged in or approved by a significant portion of the power generation industry in United States), that, in the exercise of reasonable prudent judgment in light of the facts known or that should reasonably have been known at the time a decision was made, would have been expected to accomplish the desired result consistent with good engineering practices, safety, reliability, and good business practices, and which practices, methods, standards and acts conform to a majority of the operation and maintenance standards followed by power generating plants of similar type, size and capacity as the Premises. Prudent Utility Practices are not limited to the optimum practice or method to the

exclusion of others, but rather refer to the reasonable practices and methods used by a significant portion of the power generation industry in the United States. Trustor shall complete promptly and in a good and workmanlike manner any Improvement that may be now or hereafter constructed on the Premises and promptly restore in like manner any Improvements that may be damaged or destroyed from any cause whatsoever and pay when due all claims for labor performed and materials furnished therefor. Trustor shall comply with all Requirements (as defined below) and shall not suffer to occur or exist any violation of any Requirement. Trustor shall not commit or permit any waste or deterioration of the Trust Estate, and, to the extent allowed by law, shall keep and maintain abutting grounds, sidewalks, roads, parking and landscape areas in good and neat order and repair. Trustor shall perform its obligations under each Lease. "Requirement" and "Requirements" mean, respectively, each and all obligations and requirements now or hereafter in effect by which Trustor or the Trust Estate are bound or which are otherwise applicable to the Trust Estate, construction of any Improvements on the Trust Estate, or operation, occupancy or use of the Trust Estate (including, without limitation (i) such obligations and requirements imposed by common law or any law, statute, ordinance, regulation, or rule (federal, state, or local), and (ii) such obligations and requirements of, in, or in respect of (A) any consent, authorization, license, permit, or approval relating to the Trust Estate, (B) any condition, covenant, restriction, easement, or right-of-way reservation applicable to the Trust Estate, (C) any Lien or Encumbrance, (D) any other agreement, document, or instrument to which Trustor is a party or by which Trustor or the Trust Estate is bound or affected, and (E) any order, writ, judgment, injunction, decree, determination, or award of any arbitrator, other private adjudicator, court, government, or governmental authority (federal, state, or local) to which Trustor is a party or by which Trustor or the Trust Estate is bound or affected).

1.02 Required Insurance. Trustor shall at all times provide, maintain and keep in force or cause to be provided, maintained and kept in force with respect to the Trust Estate, at no expense to Trustee or Beneficiary, policies of insurance in forms and amounts and issued by companies reasonably satisfactory to Beneficiary covering such casualties, risks, perils, liabilities and other hazards as is required under the Loan Agreement. All such policies of insurance required by the terms of this Deed of Trust or the Loan Agreement shall contain an endorsement or agreement by the insurer that any loss shall be payable in accordance with the terms of such policy notwithstanding any act or negligence of Trustor or any party holding under Trustor that might otherwise result in forfeiture of said insurance and the further agreement of the insurer waiving all rights of setoff, counterclaim or deductions against Trustor.

1.03 Delivery of Policies, Payment of Premiums.

(a) At Beneficiary's option all policies of insurance shall either have attached thereto a lender's loss payable endorsement for the benefit of Beneficiary in form satisfactory to Beneficiary or shall name Beneficiary as an additional insured. Trustor shall furnish Beneficiary with certificates of insurance for each required policy setting forth the coverage, the limits of liability, the name of the carrier, the policy number and the period of coverage. If Beneficiary consents, Trustor may provide any of the required insurance through blanket policies carried by Trustor and covering more than one location, or by policies procured by a tenant or other party holding under Trustor; provided, however, all such policies shall meet the requirements referred to in Section 1.02. At least thirty (30) days prior to the expiration of each required policy, Trustor

shall deliver to Beneficiary evidence reasonably satisfactory to Beneficiary of the payment of premium and the renewal or replacement of such policy continuing insurance in form as required by this Deed of Trust. All such policies shall contain a provision that, notwithstanding any contrary agreement between Trustor and insurance company, such policies will not be cancelled, allowed to lapse without renewal, surrendered or materially amended, which term shall include any reduction in the scope or limits of coverage, without at least thirty (30) days' prior written notice to Beneficiary.

(b) In the event Trustor fails to obtain, maintain, or deliver to Beneficiary the policies of insurance with respect to the Trust Estate required by this Deed of Trust, Beneficiary may, at Beneficiary's election, but without any obligation so to do, procure such insurance or single-interest insurance for such risks covering Beneficiary's interest, and Trustor will pay all premiums thereon promptly upon demand by Beneficiary, and until such payment is made by Trustor, the amount of all such premiums shall bear interest at the Default Rate. Upon the occurrence and during the continuation of an Event of Default and request by Beneficiary, Trustor shall deposit with Beneficiary in monthly installments, an amount equal to one-twelfth (1/12) of the estimated aggregate annual insurance premiums on all policies of insurance required by this Deed of Trust (funds deposited for this purpose are referred to as "Insurance Impounds"). In such event Trustor further agrees to cause all bills, statements, or other documents relating to the foregoing insurance premiums to be sent or mailed directly to Beneficiary. Upon receipt of such bills, statements, or other documents evidencing that a premium for a required policy is then payable, and provided there are sufficient Insurance Impounds, Beneficiary shall timely pay such amounts as may be due thereunder out of the Insurance Impounds. If at any time and for any reason the Insurance Impounds are or will be insufficient to pay such amounts as may be then or subsequently due, Beneficiary shall notify Trustor and Trustor shall immediately deposit an amount equal to such deficiency with Beneficiary. Notwithstanding the foregoing, nothing contained herein shall cause Beneficiary to be deemed a trustee of Insurance Impounds or to be obligated to pay any amounts in excess of the amount of the Insurance Impounds, nor shall anything contained herein modify the obligation of Trustor set forth in Section 1.01 to obtain and maintain insurance. Beneficiary may commingle Insurance Impounds with its own funds, and Trustor shall not be entitled to interest thereon. Beneficiary may reserve for future payments of premiums such portion of Insurance Impounds as Beneficiary in its absolute and sole discretion deems proper. If Trustor fails to deposit with Beneficiary sums sufficient to pay fully such premiums at least thirty (30) days before delinquency thereof, Beneficiary may, at Beneficiary's election, but without any obligation so to do, advance any amounts required to make up the deficiency, which advances, if any, shall be secured hereby and shall be repayable to Beneficiary upon demand with interest from the date advanced at the Default Rate, or at the option of Beneficiary the latter may, without making any advance whatever, apply any Insurance Impounds to payment of the Obligations in such order as Beneficiary may determine, notwithstanding that such Obligations may not yet be due. Upon the occurrence of an Event of Default, Beneficiary may, at any time, at Beneficiary's option, apply any Insurance Impounds or Impositions Impounds under this Section 1.03 or Section 1.07, any funds paid as Rents, and any other funds of Trustor held by Beneficiary to payment of any of the Obligations, in such manner and order as Beneficiary may elect, notwithstanding that such Obligations may not yet be due.

1.04 Casualties; Insurance Proceeds.

(a) Trustor shall give prompt written notice thereof to Beneficiary after the happening of any casualty to or in connection with the Trust Estate or any part thereof, whether or not covered by insurance. All proceeds of insurance shall be payable to Beneficiary, and Trustor hereby authorizes and directs any affected insurance company to make payment of such proceeds directly to Beneficiary. If Trustor receives any proceeds of insurance resulting from such casualty, Trustor shall promptly pay over such proceeds to Beneficiary. All proceeds of insurance will be applied by Beneficiary to payment of the Obligations in such order as Beneficiary shall determine.

(b) Trustor shall not be excused from repairing or maintaining the Trust Estate as provided in Section 1.01 hereof or restoring all damage or destruction to the Trust Estate, regardless of whether or not there are insurance proceeds available to Trustor or whether any such proceeds are sufficient in amount, and the application or release by Beneficiary of any insurance proceeds shall not cure or waive any default or notice of default under this Deed of Trust or invalidate any act done pursuant to such default or notice of default.

1.05 Assignment of Policies Upon Foreclosure. In the event of foreclosure of this Deed of Trust as a mortgage, a sale under the power of sale, or any other transfer of title or assignment of the Trust Estate in extinguishment, in whole or in part, of the Obligations, all right, title and interest of Trustor in and to all policies of insurance required by Section 1.02 shall inure to the benefit of and pass to the successor in interest to Trustor or the purchaser or grantee of the Trust Estate, to the extent such policies are assignable pursuant to the terms thereof.

1.06 Indemnification; Subrogation; Waiver of Offset.

(a) If Beneficiary is made a party to any litigation concerning the Notes, this Deed of Trust, any of the Financing Documents, the Trust Estate or any part thereof or interest therein, or the occupancy of the Trust Estate by Trustor, which litigation is not the result of a claim or counterclaim made by Trustor or Borrower against Beneficiary for breach of Beneficiary's obligations under the Financing Documents (each, an "Excluded Claim"), then Trustor shall indemnify, defend and hold Beneficiary harmless for, from and against all liability by reason of said litigation, including reasonable attorneys' fees and expenses incurred by Beneficiary as a result of any such litigation, whether or not any such litigation is prosecuted to judgment. Beneficiary may employ an attorney or attorneys to protect its rights hereunder, and in the event of such employment following any breach by Trustor, Trustor shall pay Beneficiary reasonable attorneys' fees and expenses incurred by Beneficiary, whether or not an action is actually commenced against Trustor by reason of its breach.

(b) Trustor waives any and all right to claim or recover against Beneficiary, its successors and assigns, their directors, officers, employees, agents and representatives, for loss of or damage to Trustor, the Trust Estate, Trustor's property or the property of others under Trustor's control from any cause insured against or required to be insured against by this Deed of Trust.

(c) All sums payable by Trustor pursuant to this Deed of Trust shall be paid without notice (except for such notice as may be expressly required hereunder or under the other Financing Documents), demand, counterclaim, setoff, deduction or defense and without abatement, suspension, deferment, diminution or reduction, and the obligations and liabilities of Trustor hereunder shall in no way be released, discharged or otherwise affected (except as expressly provided herein) by reason of: (i) any damage to or destruction of or any condemnation or similar taking of the Trust Estate or any part thereof; (ii) any restriction or prevention of or interference by any Person (as defined below) with any use of the Trust Estate or any part thereof; (iii) any title defect or encumbrance or any eviction from the Premises or the Improvements or any part thereof by title paramount or otherwise; or (iv) any bankruptcy, insolvency, reorganization, composition, adjustment, dissolution, liquidation or other like proceeding relating to Beneficiary, or any action taken with respect to this Deed of Trust by any trustee or receiver of Beneficiary, or by any court, in any such proceeding. Except as expressly provided herein, Trustor waives all rights now or hereafter conferred by statute or otherwise to any abatement, suspension, deferment, diminution or reduction of any sum secured hereby and payable by Trustor. "Person" means any natural person, any unincorporated association, any corporation, any partnership, any joint venture, any trust, any other legal entity, or any governmental authority (federal, state, local or foreign), excluding Beneficiary.

1.07 Impositions.

(a) Trustor shall pay, or cause to be paid, prior to delinquency, all real property taxes and assessments, general and special, and all other taxes and assessments of any kind or nature whatsoever, (including, without limitation, nongovernmental levies or assessments such as maintenance charges, levies, or charges resulting from covenants, conditions and restrictions affecting the Trust Estate) that are assessed or imposed upon the Trust Estate or become due and payable and that create, may create, or appear to create a lien upon the Trust Estate (the above are sometimes referred to herein individually as an "Imposition" and collectively as "Impositions"), provided, however, that if by law any Imposition is payable, or may at the option of the taxpayer be paid, in installments, Trustor may pay the same or cause it to be paid, together with any accrued interest on the unpaid balance of such Imposition, in installments as the same becomes due and before any fine, penalty, interest, or cost may be added thereto for the nonpayment of any such installment and interest.

(b) If at any time after the date hereof there shall be assessed or imposed a fee, tax, or assessment on Beneficiary and measured by or based in whole or in part upon this Deed of Trust or the outstanding amount of the Obligations, then all such taxes, assessments or fees shall be deemed to be included within the term "Impositions" as defined in Section 1.07(a) and Trustor shall pay and discharge the same as herein provided with respect to the payment of Impositions. If Trustor fails to pay such Impositions prior to delinquency, Beneficiary may declare all or part of the Obligations, immediately due and payable. If Trustor is prohibited by law from paying such Impositions, Beneficiary may declare all or part of the Obligations due and payable on a

date which is not less than six (6) months from the date such prohibition is imposed on Trustor.

(c) Subject to the provisions of Section 1.07(d) and upon request by Beneficiary, Trustor shall deliver to Beneficiary within thirty (30) days after the date upon which any Imposition is due and payable by Trustor official receipts of the appropriate taxing authority, or other proof satisfactory to Beneficiary, evidencing the payment thereof.

(d) Trustor shall have the right before any delinquency occurs to contest or object to the amount or validity of any Imposition by appropriate proceedings, but this shall not be deemed or construed in any way as relieving, modifying, or extending Trustor's covenant to pay any such Imposition at the time and in the manner provided in this Section 1.07, unless Trustor has given prior written notice to Beneficiary of Trustor's intent to so contest or object to an Imposition, and unless, in Beneficiary's absolute and sole discretion, (i) Trustor shall demonstrate to Beneficiary's satisfaction that the proceedings to be initiated by Trustor shall conclusively operate to prevent the sale of the Trust Estate or any part thereof or interest therein to satisfy such Imposition prior to final determination of such proceedings, (ii) Trustor shall furnish a good and sufficient bond or surety as requested by and satisfactory to Beneficiary, or (iii) Trustor shall demonstrate to Beneficiary's satisfaction that Trustor has provided a good and sufficient undertaking as may be required or permitted by law to accomplish a stay of any such sale.

(e) Upon the occurrence and during the continuation of an Event of Default and upon request by Beneficiary, Trustor shall pay to Beneficiary an initial cash deposit in an amount adequate to pay all Impositions for the ensuing tax fiscal year and shall thereafter continue to deposit with Beneficiary, in monthly installments, an amount equal to one-twelfth (1/12) of the sum of the annual Impositions reasonably estimated by Beneficiary, for the purpose of paying the installment of Impositions next due (funds deposited for this purpose are referred to as "Impositions Impounds"). In such event, Trustor further agrees to cause all bills, statements, or other documents relating to Impositions to be sent or mailed directly to Beneficiary. Upon receipt of such bills, statements, or other documents, and providing there are sufficient Impositions Impounds, Beneficiary shall timely pay such amounts as may be due thereunder out of the Impositions Impounds. If at any time and for any reason the Impositions Impounds are or will be insufficient to pay such amounts as may then or subsequently be due, Beneficiary may notify Trustor and upon such notice Trustor shall deposit immediately an amount equal to such deficiency with Beneficiary. Notwithstanding the foregoing, nothing contained herein shall cause Beneficiary to be deemed a trustee of Impositions Impounds or to be obligated to pay any amounts in excess of the amount of funds deposited with Beneficiary pursuant to this Section 1.07(e). Beneficiary may commingle Impositions Impounds with its own funds and shall not be obligated to pay any interest on any Impositions Impounds. Beneficiary may reserve for future payment of Impositions such portion of Impositions Impounds as Beneficiary may in its absolute and sole discretion deem proper. If Trustor fails to deposit with Beneficiary sums sufficient to fully pay such Impositions at least thirty (30) days before delinquency thereof, Beneficiary may, at Beneficiary's election, but without any obligation so to do, advance any amounts required

to make up the deficiency, which advances, if any, shall be secured hereby and shall be repayable to Beneficiary upon demand together with interest thereon at the Default Rate from the date of such advance, or at the option of Beneficiary the latter may, without making any advance whatever, apply any Impositions Impounds held by it upon any of the Obligations in such order as Beneficiary may determine, notwithstanding that such Obligations may not yet be due.

(f) Trustor shall not initiate or suffer to occur or exist the joint assessment of any real and personal property included in the Trust Estate or any other procedure whereby the lien of real property taxes and the lien of personal property taxes shall be assessed, levied, or charged to the Trust Estate as a single lien.

1.08 Utilities. Trustor shall pay when due all charges that are incurred by Trustor for the benefit of the Trust Estate or that may become a charge or lien against the Trust Estate for gas, electricity, water, sewer, or other services furnished to the Trust Estate.

1.09 Actions Affecting Trust Estate. Except for Excluded Claims, Trustor shall appear in and contest any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee; and shall pay all costs and expenses (including, without limitation, costs of evidence of title, litigation, and attorneys' fees) in any such action or proceeding in which Beneficiary or Trustee may appear.

1.10 Actions By Trustee or Beneficiary. If either Borrower or Trustor fails to make any payment or to do any act as and in the manner provided in any of the Financing Documents, Beneficiary and/or Trustee, each in its absolute and sole discretion, without obligation so to do, without releasing Trustor from any obligation, and with only such notice to or demand upon Trustor as may be reasonable under the then existing circumstances, but in no event exceeding ten (10) days prior written notice, may make or do the same in such manner and to such extent as either may deem necessary or appropriate. In connection therewith (without limiting their general powers, whether conferred herein, in another Financing Document or by law), Beneficiary and Trustee shall have and are hereby given the right, but not the obligation, (a) to enter upon and take possession of the Trust Estate; (b) to make additions, alterations, repairs and improvements to the Trust Estate that they or either of them may consider necessary or appropriate to keep the Trust Estate in good condition and repair; (c) to appear and participate in any action or proceeding affecting or which may affect the security hereof or the rights or powers of Beneficiary or Trustee; (d) to pay, purchase, contest or compromise any Lien or Encumbrance (as defined below) or alleged Lien or Encumbrance whether superior or junior to this Deed of Trust; and (e) in exercising such powers, to pay necessary expenses (including, without limitation, expenses of employment of counsel or other necessary or desirable consultants). Trustor shall, immediately upon demand therefor by Beneficiary and Trustee or either of them, pay to Beneficiary and Trustee an amount equal to all respective costs and expenses incurred by them in connection with the exercise by either Beneficiary or Trustee or both of the foregoing rights (including, without limitation, costs of evidence of title, court costs, appraisals, surveys and receiver's, trustee's and attorneys' fees) together with interest thereon from the date of such expenditures at the Default Rate.

1.11 Transfer of Trust Estate by Trustor. Trustor agrees that, in the event of any Transfer (as hereinafter defined), without the prior written consent of Beneficiary, Beneficiary shall have the absolute right, without prior demand or notice, to declare all sums secured hereby immediately due and payable. Consent to one such transaction shall not be deemed to be a waiver of the right to require consent to future or successive transactions. Beneficiary may grant or deny such consent in its sole discretion and, if consent should be given, any such Transfer shall be subject to this Deed of Trust, and such transferee shall assume all obligations hereunder and agree to be bound by all provisions contained herein. Such assumption shall not, however, release Trustor or any maker or guarantor (if any) of the Notes from any liability thereunder without the prior written consent of Beneficiary. As used herein, "Transfer" shall mean:

(i) any sale, transfer, conveyance, hypothecation, encumbrance, lease or vesting of the Trust Estate or any part thereof or interest therein to or in any Person, whether voluntary, involuntary, by operation of law, or otherwise, except the Permitted Exceptions (as such term is defined in Exhibit C attached hereto and incorporated herein by reference);

(ii) any sale, transfer, assignment, conveyance, hypothecation, encumbrance or vesting of any shares of stock in Trustor to or in any Person or any consolidation or merger of Trustor into or with any Person whether voluntary, involuntary, by operation of law, or otherwise, except the Permitted Exceptions; or

(iii) the execution of any agreements to do any of the foregoing, except the Permitted Exceptions;

provided, however, that the term "Transfer" shall not include the transfer by Borrower of the capital stock of Trustor, so long as (a) such transfers are made either: (1) to entities that are controlled by, controlling or under common control with Trustor and Borrower, or (2) to other persons, provided that after giving effect to such transfers pursuant to this clause (a)(2) Borrower continues to own (free and clear of Liens and Encumbrances) at least a 51% interest in Trustor and (b) such transfers do not result in the dissolution or winding up of Trustor.

1.12 Eminent Domain.

(a) In the event that any proceeding or action be commenced for the taking of the Trust Estate, or any part thereof or interest therein, for public or quasi-public use under the power of eminent domain, condemnation (including, without limitation, inverse condemnation) or otherwise (hereinafter collectively referred to as a "Taking"), or if the same be taken or damaged by reason of any public improvement or Taking, or should Trustor receive any notice or other information regarding such Taking or damage, Trustor shall give prompt written notice thereof to Beneficiary. All compensation, awards, damages, rights of action and proceeds awarded to Trustor by reason of any such Taking or damage or received by Trustor as the result of a transfer in lieu of a Taking (the "Condemnation Proceeds") are hereby assigned to Beneficiary, and Trustor agrees to execute such further assignments of the Condemnation Proceeds as Beneficiary or Trustee may require. If Trustor receives any Condemnation Proceeds Trustor shall

promptly pay over such proceeds to Beneficiary. Beneficiary is hereby authorized and empowered by Trustor, at Beneficiary's option and in Beneficiary's sole discretion, as attorney-in-fact for Trustor, to settle, adjust, or compromise any claim for loss or damage in connection with any Taking or proposed Taking and, without regard to the adequacy of its security, to commence, appear in and prosecute in its own name and/or on behalf of Trustor any such action or proceeding arising out of or relating to a Taking or proposed Taking.

(b) Trustor shall not be excused from repairing or maintaining the Trust Estate as provided in Section 1.01 or restoring all damage or destruction to the Trust Estate, regardless of whether or not there are Condemnation Proceeds available to Trustor or whether any such Condemnation Proceeds are sufficient in amount. The application or release of the Condemnation Proceeds shall not cure or waive any default or notice of default hereunder or under any other Financing Document or invalidate any act done pursuant to such default or notice of default.

1.13 Additional Security. No other security now existing, or hereafter taken, to secure the obligations secured hereby shall be impaired or affected by the execution of this Deed of Trust. All security for the Obligations from time to time shall be taken, considered and held as cumulative. Any taking of additional security, execution of partial releases of the security, or any extension of the time of payment of, or modification of other terms of any of the Obligations shall not diminish the force, effect or lien of this Deed of Trust and shall not affect or impair the liability of any maker, guarantor, surety or endorser for the payment or performance of any of the Obligations. In the event Beneficiary at any time holds additional security for any of the Obligations, it may enforce the sale thereof or otherwise realize upon the same, at its option, either before, concurrently with, or after a sale or realization is made hereunder.

1.14 Appointment of Successor Trustee. Beneficiary may, from time to time, by a written instrument executed and acknowledged by Beneficiary, mailed to Trustor and recorded in the county in which the Trust Estate is located and by otherwise complying with the provisions of applicable law, substitute a successor or successors to any Trustee named herein or acting hereunder, and such successor(s) shall, without conveyance from the Trustee predecessor, succeed to all title, estate, rights, powers and duties of such predecessor.

1.15 Inspections. Beneficiary, and its agents, representatives officers, and employees, are authorized to enter at any reasonable time upon or in any part of the Trust Estate for the purpose of inspecting the same and for the purpose of performing any of the acts Beneficiary is authorized to perform hereunder or under the terms of any of the Financing Documents.

1.16 Ownership and Liens and Encumbrances. Trustor is, and as to any portion of the Trust Estate acquired hereafter will upon such acquisitions be, and shall remain the owner of the Trust Estate free and clear of any Liens and Encumbrances. Trustor shall not grant, shall not suffer to exist, and shall pay and promptly discharge, at Trustor's cost and expense, all Liens and Encumbrances and any claims thereof upon the Trust Estate, or any part thereof or interest therein. Trustor shall notify Beneficiary immediately in writing of any Lien or Encumbrance or claim thereof. Trustor shall have the right to contest in good faith the validity of any involuntary Lien or Encumbrance, provided Trustor shall first deposit with Beneficiary a bond or other

security satisfactory to Beneficiary in such amount as Beneficiary shall reasonably require, but not more than one hundred fifty percent (150%) of the amount of the claim, and provided further that if Trustor loses such contest, Trustor shall thereafter diligently proceed to cause such Lien or Encumbrance to be removed and discharged. If Trustor shall fail to remove and discharge any Lien or Encumbrance or claim thereof, then, in addition to any other right or remedy of Beneficiary, Beneficiary may, after only such notice to Trustor as may be reasonable under the then existing circumstances, but shall not be obligated to, discharge the same, either by paying the amount claimed to be due, or by procuring the discharge of such Lien or Encumbrance by depositing in a court a bond or the amount claimed or otherwise giving security for such claim, or by procuring such discharge in such manner as is or may be prescribed by law. Trustor shall, immediately upon demand therefor by Beneficiary, pay to Beneficiary an amount equal to all costs and expenses incurred by Beneficiary in connection with the exercise by Beneficiary of the foregoing right to discharge any Lien or Encumbrance or claim thereof, together with interest thereon from the date of each such expenditure at the Default Rate. Such costs and expenses shall be secured by this Deed of Trust. "Lien or Encumbrance" and "Liens and Encumbrances" mean, respectively, each and all of the following in respect of the Trust Estate: leases, other rights to occupy or use, mortgages, deeds of trust, pledges, security agreements, assignments, assignments as security, conditional sales, title retention arrangements or agreements, conditions, covenants, and restrictions, and other charges, liens, encumbrances, or adverse interests, whether voluntarily or involuntarily created and regardless of whether prior or subordinate to any estate, right, title, or interest granted to Trustee or Beneficiary in this Deed of Trust, excluding from the foregoing the Permitted Exceptions.

1.17 Trustee's Powers. At any time, or from time to time, without liability therefor and without notice, upon written request of Beneficiary and presentation of this Deed of Trust and without affecting the personal liability of any person for payment of the Obligations or the effect of this Deed of Trust upon the remainder of said Trust Estate, Trustee may (a) reconvey any part of said Trust Estate, (b) consent in writing to the making of any map or plat thereof, (c) join in granting any easement thereon, or (d) join in any extension agreement or any agreement subordinating the lien or charge hereof.

1.18 Beneficiary's Powers. Without affecting the liability of any Person liable for the payment of the Obligations herein mentioned, and without affecting the lien or charge of this Deed of Trust upon any portion of the Trust Estate not then or theretofore released as security for the Obligations, Beneficiary may, from time to time and without notice (a) release any person so liable, (b) extend the Obligations, (c) grant other indulgences, (d) release or reconvey, or cause to be released or reconveyed, at any time at Beneficiary's option any parcel, portion or all of the Trust Estate, (e) take or release any other or additional security or any guaranty for any Obligation herein mentioned, or (f) make compositions or other arrangements with debtors in relation thereto.

1.19 Trade Names. At the request of Beneficiary from time to time, Trustor shall execute a certificate in form satisfactory to Beneficiary listing the trade names or fictitious business names under which Trustor intends to operate the Trust Estate or any business located thereon and representing and warranting that Trustor does business under no other trade names or fictitious business names with respect to the Trust Estate. Trustor shall immediately notify Beneficiary in writing of any change in said trade names or fictitious business names, and will,

upon request of Beneficiary, execute any additional financing statements and other certificates necessary to reflect the change in trade names or fictitious business names.

1.20 Leasehold. If a leasehold estate constitutes a portion of the Trust Estate, Trustor agrees not to amend, modify, extend, renew or terminate such leasehold estate, any interest therein, or the lease granting such leasehold estate without the prior written consent of Beneficiary, which consent may be withheld by Beneficiary in its absolute and sole discretion. Consent to one amendment, modification, extension or renewal shall not be deemed to be a waiver of the right to require consent to other, future or successive amendments, modifications, extensions or renewals. Trustor agrees to perform all obligations and agreements under said leasehold and shall not take any action or omit to take any action which would effect or permit the termination of said leasehold. Trustor agrees to promptly notify Beneficiary in writing with respect to any default or alleged default by any party thereto and to deliver to Beneficiary copies of all notices, demands, complaints or other communications received or given by Trustor with respect to any such default or alleged default. Beneficiary shall have the option to cure any such default and to perform any or all of Trustor's obligations thereunder. All sums expended by Beneficiary in curing any such default shall be secured hereby and shall be immediately due and payable without demand or notice and shall bear interest from date of expenditure at the Default Rate.

1.21 Environmental Matters. Trustor shall not use, generate, manufacture, store or dispose of, in, under or about the Trust Estate or transport to or from the Trust Estate any Hazardous Materials, except for those Hazardous Materials used, generated, manufactured, stored or disposed of in material compliance with all applicable Environmental Laws. For purposes of this Deed of Trust, "Environmental Laws" shall mean all federal, state or local laws, whether common law, statute, ordinance, rule, regulation, or judicial or administrative decision or policy or guideline, pertaining to Hazardous Materials, health, industrial hygiene, environmental conditions, or the regulation or protection of the environment, and all amendments thereto as of this date and to be added in the future and any successor statute or rule or regulation promulgated thereto. For purposes of this Deed of Trust, "Hazardous Materials" shall include, but shall not be limited to (i) flammable explosives, radioactive materials, hazardous wastes, toxic substances or related materials, (ii) all substances defined as "hazardous substances," "hazardous materials," or "toxic substances" in the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended, 42 U.S.C. §9601, et seq.; the Hazardous Materials Transportation Act, 49 U.S.C. §1901, et seq.; the Resource Conservation and Recovery Act, 42 U.S.C. §6901, et seq.; and (iii) all substances defined as "hazardous substances" in Arizona Revised Statutes §49-201 (16). Except for the use, generation, storage, release, threatened release, discharge, or disposal of Hazardous Materials on, under or about the Trust Estate attributable to (a) Beneficiary's prior ownership of the Trust Estate, (b) Beneficiary's operation of the Trust Estate or (c) Beneficiary's operations on property adjacent to the Trust Estate, Trustor shall be solely responsible for, and shall indemnify and hold harmless Beneficiary, its directors, officers, employees, agents, successors and assigns from and against, any loss, damage, cost, expense or liability directly or indirectly arising out of or attributable to the use, generation, storage, release, threatened release, discharge, disposal, or presence of Hazardous Materials on, under or about the Trust Estate, including without limitation: (1) all foreseeable consequential damage; (2) the costs of any required or necessary repairs, cleanup or detoxification of the Trust Estate, and the preparation and implementation of any closure,

remedial or other required plans; and (3) all reasonable costs and expenses incurred by Beneficiary in connection with clauses (1) and (2), including but not limited to reasonable attorneys' fees. Beneficiary, or its agents, shall have the right to enter onto the Trust Estate to inspect the Premises and to perform any testing of the Trust Estate for the existence of Hazardous Materials and to determine compliance with all environmental laws. Any such inspection by Beneficiary shall not relieve Trustor of its obligations to comply with any such environmental law, rule or regulation.

1.22 Rights of Beneficiary. With respect to the Obligations, Trustor authorizes Beneficiary to perform any or all of the following acts at any time in its sole discretion, all without notice to or the consent or approval of Trustor and without affecting Trustor's obligations under this Deed of Trust:

(a) Beneficiary may alter any Obligation, including renewing, compromising, extending or accelerating, or otherwise changing the time for payment of, or increasing or decreasing the rate of interest on, all or any part of any Obligation.

(b) Beneficiary may take and hold security for any Obligation, accept additional or substituted security therefor, and subordinate, exchange, enforce, waive, release, compromise, fail to perfect, and sell or otherwise dispose of any such security.

(c) Beneficiary may direct the order and manner of any public or private sale of all or any part of any security assigned to Beneficiary by Borrower or any other person, or otherwise to comply with the Uniform Commercial Code of Arizona with respect to any personal property collateral, and Beneficiary may also bid at any such sale.

(d) Beneficiary may apply any payments or recoveries from Borrower, any guarantor (a "Guarantor") of any Obligation or any other source, and any proceeds of any security, to the Obligations in such manner, order and priority as Beneficiary may elect, whether or not those obligations are secured at the time of the application.

(e) Beneficiary may release Borrower or any other person of its liability for all or any part of any Obligation.

(f) Beneficiary may substitute, add, or release any one or more Guarantors or endorsers.

(g) In addition to the Obligations, Beneficiary may extend other credit to Borrower, and may take and hold security for the credit so extended, all without affecting Trustor's liability under this Deed of Trust.

1.23 Trustor's Waivers. Trustor waives:

(a) Any right it may have to require Beneficiary to proceed against Borrower or any other person, proceed against or exhaust any security held from Borrower or any other person, or pursue any other remedy in Beneficiary's power to pursue;

(b) Any defense based on any claim that Trustor's obligations exceed or are more burdensome than those of Borrower;

(c) Any defense based on (i) any legal disability of Borrower or any other Person, (ii) any release, discharge, modification, impairment, or limitation of the liability of Borrower or any other person to Beneficiary from any cause, whether consented to by Beneficiary or arising by operation of law or from any bankruptcy or other voluntary or involuntary proceeding, in or out of court, for the adjustment of debtor-creditor relationships ("Insolvency Proceeding"), and (iii) any rejection or disaffirmance of all or any part of any Obligation, or any security therefor, in any such Insolvency Proceeding;

(d) Any defense based on any action taken or omitted by Beneficiary in any Insolvency Proceeding involving Borrower, including any election to have Beneficiary's claim allowed as being secured, partially secured or unsecured, any extension of credit by Beneficiary to Borrower in any Insolvency Proceeding, and the taking and holding by Beneficiary of any security for any such extension of credit;

(e) All presentments, demands for performance, notices of nonperformance, protests, notices of protest, notices of dishonor, and of the existence, creation, or incurring of new or additional indebtedness, and demands and notices of every kind;

(f) Any defense based on or arising out of any defense that Borrower may have to the payment or performance of all or any part of any Obligation;

(g) Any defense based on the unenforceability or invalidity of any collateral assignment or guaranty with respect to any Obligation, or the lack of perfection or continuing perfection or lack of priority of any lien (other than the lien of this Deed of Trust) which secures any Obligation; and

(h) Any failure of Beneficiary to marshal assets in favor of Trustor or any other person.

1.24 Information Regarding Borrower and the Property. Trustor warrants and agrees that Trustor has not relied, and will not rely, on any representations and warranties by Beneficiary to Trustor with respect to the creditworthiness of Borrower or the prospects of repayment of any Obligation from sources other than the Trust Estate. Before signing this Deed of Trust, Trustor will have investigated the financial condition and business operations of Borrower, the present and former condition, uses and ownership of the Trust Estate, and such other matters as Trustor may deem appropriate to assure itself of Borrower's ability to discharge its obligations under or with respect to the Obligations. Trustor assumes full responsibility for such due diligence, as well as for keeping informed of all matters which may affect Borrower's ability to pay and perform its obligations to Beneficiary. Beneficiary has no duty to disclose to Trustor any information which Beneficiary may have or receive about Borrower's financial condition or business operations, the condition or uses of any of the Trust Estate, or any other circumstances bearing on Borrower's ability to perform. Trustor is familiar with the terms and conditions of the Loan Documents and consents to all provisions thereof.

1.25 Subordination. Any rights of Trustor, whether now existing or later arising, to receive payment on account of any indebtedness (including interest) owed to it by Borrower or any subsequent owner of any of the Trust Estate, or to withdraw capital invested by it in Borrower (if applicable), or to receive distributions from Borrower (if applicable), shall at all times be subordinate as to lien and time of payment and in all other respects to the full and prior repayment to Beneficiary of all Obligations; provided, however, that prior to the occurrence of an Event of Default, Trustor may receive payments of such subordinated obligations in the ordinary course of business and in a manner that is consistent with past practices.

1.26 Consideration.

(a) Trustor acknowledges that it expects to benefit from Beneficiary's entering into certain material transactions with respect to the Obligations because of Trustor's relationship to Borrower, and that it is executing this Deed of Trust in consideration of such anticipated benefit.

(b) Trustor does not intend to defraud any of its creditors by execution and delivery of this Deed of Trust. Trustor is not insolvent, and Trustor shall not be rendered insolvent by virtue of such execution of this Deed of Trust. Trustor has determined that, in its opinion, the fair market value of the benefits to be derived by it from such execution of this Deed of Trust will equal or exceed the cost and expense that may be incurred by Trustor under or in connection with this Deed of Trust.

1.27 Lawfulness and Reasonableness. Trustor warrants that all of the waivers in this Deed of Trust are made with full knowledge of their significance, and of the fact that events giving rise to any defense or other benefit waived by Trustor may destroy or impair rights which Trustor would otherwise have against Beneficiary, Borrower and other persons, or against collateral. Trustor agrees that (i) all such waivers are reasonable under the circumstances and (ii) if any such waiver is determined (by a court of competent jurisdiction) to be contrary to any law or public policy, the other waivers herein shall nonetheless remain in full force and effect.

1.28 Limitation on Amount Obligated; Contribution by Other Persons. Anything contained in this Deed of Trust to the contrary notwithstanding, if any Fraudulent Transfer Law (as hereinafter defined) is determined by a court of competent jurisdiction to be applicable to the obligations of Trustor under this Deed of Trust, such obligations shall be limited to a maximum aggregate amount equal to the largest amount that would not render Trustor's obligations under this Deed of Trust subject to avoidance as a fraudulent transfer or conveyance under Section 548 of Title 11 of the United States Code or any applicable provisions of comparable state law (collectively, the "Fraudulent Transfer Laws"), in each case after giving effect to all other liabilities of Trustor, contingent or otherwise, that are relevant under the Fraudulent Transfer Laws (specifically excluding, however, any liabilities of Trustor in respect of intercompany indebtedness, if any, to Borrower or any Affiliate (as defined in the Loan Agreement) of Borrower to the extent that such indebtedness would be discharged in an amount equal to the amount paid by Trustor under this Deed of Trust pursuant to which the liability of Trustor under this Deed of Trust is included in the liabilities taken into account in determining such maximum amount) and after giving effect as assets to the value (as determined under the applicable provisions of the Fraudulent Transfer Laws) of any rights to subrogation, reimbursement,

indemnification, or contribution of Trustor pursuant to applicable law or pursuant to the terms of any agreement.

1.29 Enforceability. Trustor hereby acknowledges that (i) the obligations undertaken by Trustor in this Deed of Trust are complex in nature, (ii) numerous possible defenses to the enforceability of these obligations may presently exist and/or may arise hereafter, (iii) as part of Beneficiary's consideration for accepting this Deed of Trust as security for advances to be made with respect to the Loan, Beneficiary has specifically bargained for the waiver and relinquishment by Trustor of all such defenses, and (iv) Trustor has had the opportunity to seek and receive legal advice from skilled legal counsel in the area of financial transactions of the type contemplated herein. Given all of the above, Trustor hereby represents and confirms to Beneficiary that Trustor is fully informed regarding, and that Trustor does thoroughly understand, (w) the nature of all such possible defenses, (x) the circumstances under which such defenses may arise, (y) the benefits which such defenses might confer upon Trustor, and (z) the legal consequences to Trustor of waiving such defenses. Trustor acknowledges that Trustor enters into this Deed of Trust with the intent that this Deed of Trust and all of the informed waivers in this Deed of Trust shall each and all be fully enforceable by Beneficiary, and that Beneficiary is accepting this Deed of Trust in material reliance upon the presumed full enforceability thereof.

1.30 No Personal Obligation. Beneficiary agrees that (i) Trustor shall have no personal liability with respect to the Obligations and (ii) Beneficiary's recourse against Trustor for the Obligations shall be limited to Beneficiary's enforcement of its remedies against the Trust Estate as encumbered by this Deed of Trust.

## ARTICLE II
## ASSIGNMENT OF RENTS

2.01 Assignment of Rents. Trustor hereby absolutely and irrevocably assigns and transfers to Beneficiary all the Rents of the Trust Estate, and hereby gives to and confers upon Beneficiary the right, power and authority to collect the Rents. Trustor irrevocably appoints Beneficiary its true and lawful attorney-in-fact, at the option of Beneficiary at any time and from time to time, to demand, receive and enforce payment, to give receipts, releases and satisfactions, and to sue, in the name of Trustor or Beneficiary, for all Rents and apply the same to the payment of the Obligations in such order as Beneficiary shall determine. Trustor hereby authorizes and directs the lessees, tenants and occupants to make all payments under the Leases directly to Beneficiary upon written demand by Beneficiary, without further consent of Trustor; provided, however, that Trustor shall have the right to collect such Rents (but not more than one (1) month in advance unless the written approval of Beneficiary is first obtained), and to retain and enjoy same, so long as an Event of Default shall not have occurred hereunder or under the other Financing Documents. The assignment of the Rents of the Trust Estate in this Article II is intended to be an absolute assignment from Trustor to Beneficiary and not merely the passing of a security interest.

2.02 Collection Upon an Event of Default. Upon the occurrence of an Event of Default, Beneficiary may, at any time without notice, either in person, by agent or by a receiver appointed by a court, and without regard to the adequacy of any security for the Obligations, enter upon and take possession of the Trust Estate, or any part thereof, and, with or without such entry or taking possession, in its own name sue for or otherwise collect the Rents (including, without limitation, those past due and unpaid) and apply the same, less costs and expenses of operation and collection (including, without limitation, attorneys' fees) upon payment of the Obligations in such order as Beneficiary may determine. The collection of such Rents, or the entering upon and taking possession of the Trust Estate, or the application of the Rents as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done in response to such default or pursuant to such notice of default. Trustor also hereby authorizes Beneficiary upon such entry, at its option, to take over and assume the management, operation and maintenance of the Trust Estate and to perform all acts Beneficiary in its sole discretion deems necessary and proper and to expend such sums out of Rents as may be needed in connection therewith, in the same manner and to the same extent as Trustor theretofore could do (including, without limitation, the right to enter into new leases, to cancel, surrender, alter or amend the terms of, and/or renew existing leases and/or to make concessions to tenants). Trustor hereby releases all claims of any kind or nature against Beneficiary arising out of such management, operation and maintenance, excepting the liability of Beneficiary to account as hereinafter set forth.

2.03 Application of Rents. Upon such entry, Beneficiary shall, after payment of all property charges and expenses (including, without limitation, reasonable compensation to such managing agent as it may select and employ) and after the accumulation of a reserve to meet requisite amounts, credit the net amount of the Rents received by it to the Obligations, but the manner of the application of such net income and which items shall be credited shall be determined in the sole discretion of Beneficiary. Beneficiary shall not be accountable for more monies than it actually receives from the Trust Estate; nor shall it be liable for failure to collect Rents. Beneficiary shall make reasonable efforts to collect Rents, reserving, however, within its own absolute and sole discretion, the right to determine the method of collection and the extent to which enforcement of collection of Rents shall be prosecuted and Beneficiary's judgment shall be deemed conclusive and reasonable.

2.04 Mortgagee in Possession. It is not the intention of the parties hereto that an entry by Beneficiary upon the Premises under the terms of this instrument shall make Beneficiary a party in possession in contemplation of the law, except at the option of Beneficiary.

2.05 Indemnity. Except for those losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs, and expenses resulting from Beneficiary's gross negligence or willful misconduct, Trustor hereby agrees to indemnify and hold harmless Beneficiary for, from and against any and all losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs, and expenses, including legal fees and expenses, howsoever and by whomsoever asserted, arising out of or in any way connected with this assignment; and all such losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs and expenses shall be deemed added to the indebtedness secured hereby and shall be secured by any and all other instruments securing said indebtedness.

2.06 No Obligation to Perform. Nothing contained herein shall operate or be construed to obligate Beneficiary to perform any obligations of Trustor under any Lease (including, without limitation, any obligation arising out of any covenant of quiet enjoyment therein contained in the event the lessee under any such Lease shall have been joined as a party defendant in any action to foreclose and the estate of such lessee shall have been thereby terminated). Prior to actual entry into and taking possession of the Premises by Beneficiary, this assignment shall not operate to place upon Beneficiary any responsibility for the operation, control, care, management or repair of the Trust Estate or any portion thereof, and the execution of this assignment by Trustor shall constitute conclusive evidence that all responsibility for the operation, control, care, management and repair of the Trust Estate is and shall be that of Trustor, prior to such actual entry and taking of possession.

## ARTICLE III
## SECURITY AGREEMENT

3.01 Creation of Security Interest. Trustor hereby grants to Beneficiary, a security interest in and to all the Personal Property.

3.02 Representations, Warranties and Covenants of Trustor. Trustor hereby represents, warrants and covenants (which representations, warranties and covenants shall survive creation of any indebtedness of Trustor to Beneficiary and any extension of credit thereunder) as follows:

(a) The Personal Property is not used or bought for personal, family or household purposes.

(b) The tangible portion of the Personal Property will be kept on or at the Premises or Improvements and Trustor will not, without the prior written consent of Beneficiary, remove the Personal Property or any portion thereof therefrom except such portions or items of Personal Property which are consumed or worn out in ordinary usage, all of which shall be promptly replaced by Trustor with similar items of equal to or greater value.

(c) Trustor hereby authorizes Beneficiary to file and/or record financing statements and fixture filings pursuant to the Uniform Commercial Code of Arizona as in effect in the State of Arizona (Arizona Revised Statutes ("A.R.S.") Sections 47-1101 through 47-11107, as amended from time to time ("Uniform Commercial Code of Arizona")), in form satisfactory to Beneficiary and will pay the cost of recording and filing the same in all public offices wherever recording or filing is deemed by Beneficiary to be necessary or desirable.

(d) Trustor's principal place of business is in the State of Arizona at 400 North 5th Street, Phoenix, Arizona 85004. Trustor does not do business under any trade name except as previously disclosed in writing to Beneficiary. Trustor will immediately notify Beneficiary in writing of any change in its place of business or the adoption or change of any trade name or fictitious business name, and will upon request of Beneficiary, execute any additional financing statements or other certificates necessary to reflect the adoption or change in trade name or fictitious business name.

(e) Trustor shall immediately notify Beneficiary of any claim against the Personal Property adverse to the interest of Beneficiary therein.

3.03 Use of Personal Property by Trustor. Until the occurrence of an Event of Default hereunder or under any other Financing Document, Trustor may have possession of the Personal Property and use it in any lawful manner not inconsistent with this Deed of Trust and not inconsistent with any policy of insurance thereon.

3.04 Remedies Upon an Event of Default.

(a) In addition to the remedies provided in Section 4.02 hereof, upon the occurrence of an Event of Default hereunder, Beneficiary may do any one or more of the following:

(i) Either personally, or by means of a court appointed receiver, take possession of all or any of the Personal Property and exclude therefrom Trustor and all others claiming under Trustor, and thereafter hold, store, use, operate, manage, maintain and control, make repairs, replacements, alterations, additions and improvements to and exercise all rights and powers of Trustor with respect to the Personal Property or any part thereof. In the event Beneficiary demands, or attempts to take possession of the Personal Property in the exercise of any rights under this Deed of Trust, Trustor agrees to promptly turn over and deliver possession thereof to Beneficiary;

(ii) Without notice to or demand upon Trustor, make such payments and do such acts as Beneficiary may deem necessary to protect its security interest in the Personal Property (including, without limitation, paying, purchasing, contesting or compromising any Lien or Encumbrance, whether superior or inferior to such security interest) and in exercising any such powers or authority to pay all expenses (including, without limitation, litigation costs and reasonable attorney's fees) incurred in connection therewith;

(iii) Require Trustor from time to time to assemble the Personal Property, or any portion thereof, at a place designated by Beneficiary and reasonably convenient to both parties, and deliver promptly such Personal Property to Beneficiary, or an agent or representative designated by Beneficiary. Beneficiary, and its agents and representatives, shall have the right to enter upon any or all of Trustor's premises and property to exercise Beneficiary's rights hereunder;

(iv) Realize upon the Personal Property or any part thereof as herein provided or in any manner permitted by law and exercise any and all of the other rights and remedies conferred upon Beneficiary by this Deed of Trust, any other Financing Document, or by law, either concurrently or in such order as Beneficiary may determine;

(v) Sell or cause to be sold in such order as Beneficiary may determine, as a whole or in such parcels as Beneficiary may determine, the Personal Property and the remainder of the Trust Estate;

(vi) Sell, lease, or otherwise dispose of the Personal Property at public sale, upon terms and in such manner as Beneficiary may determine. Beneficiary may be a purchaser at any sale; and

(vii) Exercise any remedies of a secured party under the Uniform Commercial Code of Arizona or any other applicable law.

(b) Unless the Personal Property is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, Beneficiary shall give Trustor at least five (5) days' prior written notice of the time and place of any public sale of the Personal Property or other intended disposition thereof to be made. Such notice may be mailed to Trustor at the address set forth in Section 5.05.

(c) The proceeds of any sale under Section 3.04(a)(iv) shall be applied, unless otherwise directed by statute, as provided in Clause 7 of the Agency and Disbursement Agreement. Beneficiary shall have the right to enforce one or more remedies hereunder, successively or concurrently, and such action shall not operate to estop or prevent Beneficiary from pursuing any further remedy that it may have. Any repossession or retaking or sale of the Personal Property pursuant to the terms hereof shall not operate to release Trustor until full payment of any deficiency has been made in cash.

3.05 Security Agreement. This Deed of Trust constitutes and shall be deemed to be a "security agreement" for all purposes of the Uniform Commercial Code of Arizona and Beneficiary shall be entitled to all the rights and remedies of a "secured party" under such Uniform Commercial Code of Arizona.

3.06 Fixture Filing. Upon its recording in the real property records, this Deed of Trust shall be effective as a financing statement filed as a fixture filing. In addition, a carbon, photographic or other reproduced copy of this Deed of Trust and/or any financing statement relating hereto shall be sufficient for filing and/or recording as a financing statement. The filing of any other financing statement relating to any personal property, rights or interests described herein shall not be construed to diminish any right or priority hereunder.

## ARTICLE IV
## REMEDIES UPON DEFAULT

4.01 Events of Default. An Event of Default under the Loan Agreement shall be an Event of Default hereunder.

4.02 Acceleration Upon Default; Additional Remedies. Upon the occurrence of an Event of Default, Beneficiary may declare all or any part of the Obligations immediately due and payable without any presentment, demand, protest or notice of any kind. Beneficiary may, in addition to the exercise of any or all of the remedies specified in Section 3.04:

(a) Either in person or by agent, with or without bringing any action or proceeding, or by a receiver appointed by a court and without regard to the adequacy of its security, enter upon and take possession of the Trust Estate, or any part thereof, in its own name or in the name of Trustee, and do any acts that it deems necessary or desirable to preserve the value, marketability or rentability of the Trust Estate, or any part thereof or interest therein, increase the income therefrom or protect the security hereof and, with or without taking possession of the Trust Estate, sue for or otherwise collect the Rents, or any part thereof, including, without limitation, those past due and unpaid, and apply the same, less costs and expenses of operation and collection (including, without limitation, attorneys' fees) upon the Obligations, all in such order as Beneficiary may determine. The entering upon and taking possession of the Trust Estate, the collection of such Rents and the application thereof as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done in response to such default or pursuant to such notice of default and, notwithstanding the continuance in possession of all or any portion of the Trust Estate or the collection, receipt and application of Rents, Trustee or Beneficiary shall be entitled to exercise every right provided for in any of the Financing Documents or by law upon occurrence of any Event of Default, including, without limitation, the right to exercise the power of sale;

(b) Commence an action to foreclose the lien of this Deed of Trust as a mortgage, appoint a receiver, or specifically enforce any of the covenants hereof;

(c) Exercise of the power of sale herein contained and deliver to Trustee a written statement of breach, notice of default and election to cause Trustor's interest in the Trust Estate to be sold; or

(d) Exercise all other rights and remedies provided herein, in any Financing Document or other document or agreement now or hereafter securing or guarantying all or any portion of the Obligations, or by law, including, without limitation, the rights and remedies provided in A.R.S. Section 33-702.B.

4.03 Exercise of Power of Sale. If Beneficiary elects to exercise the power of sale herein contained, Beneficiary shall notify Trustee and shall deposit with Trustee this Deed of Trust and the Notes and such receipts and evidence of expenditures made and secured hereby as Trustee may require.

(a) Upon receipt of such statement and notice from Beneficiary, Trustee shall cause to be recorded, published and delivered to Trustor such Notice of Sale as then required by law. Trustee shall, without demand on Trustor, after lapse of such time as may then be required by law and after recordation of such Notice of Sale and Notice of Sale having been given as required by law, sell the Trust Estate at the time and place of sale fixed by it in said Notice of Sale, either as a whole, or in separate lots or parcels or items as Trustee shall deem expedient, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money of the United States payable at the time of sale. Trustee shall deliver to such purchaser or purchasers thereof its good and sufficient deed or deeds conveying the property so sold, but without any covenant or warranty, express or implied. The recitals in such deed of any matters or facts shall be

conclusive proof of the truthfulness thereof. Any person, including, without limitation, Trustor, Trustee or Beneficiary, may purchase at such sale and Trustor hereby covenants to warrant and defend the title of such purchaser or purchasers.

(b) After deducting all costs, fees and expenses of Trustee and of this Trust, including, without limitation, Trustee's fees and reasonable attorneys' fees, and costs of evidence of title in connection with sale, Trustee shall apply the proceeds of sale, unless otherwise directed by statute, in accordance with Clause 7 of the Agency and Disbursement Agreement.

(c) Subject to A.R.S. Section 33-810.B, Trustee may postpone sale of all or any portion of the Trust Estate by public announcement at such time and place of sale, and from time to time thereafter may postpone such sale by public announcement or subsequently noticed sale, and without further notice make such sale at the time fixed by the last postponement, or may, in it discretion, give a new notice of sale.

4.04 Personal Property. It is the express understanding and intent of the parties that as to any personal property interests subject to Chapter 9 of the Uniform Commercial Code of Arizona, Beneficiary, upon an Event of Default, may proceed under such Uniform Commercial Code of Arizona or may proceed as to both real and personal property interests in accordance with the provisions of this Deed of Trust and its rights and remedies in respect to real property, as specifically permitted under A.R.S. Section 47-9604.A, and treat both real and personal property interests as one parcel or package of security.

4.05 Appointment of Receiver. Upon the occurrence of an Event of Default, Beneficiary, as a matter of right and without notice to Trustor or any one claiming under Trustor, and without regard to the then value of the Trust Estate or the interest of Trustor therein, shall have the right to apply to any court having jurisdiction to appoint a receiver or receivers of the Trust Estate, and Trustor hereby irrevocably consents to such appointment and waives notice of any application therefor. Any such receiver or receivers shall have all the usual powers and duties of receivers in like or similar cases and all the powers and duties of Beneficiary in case of entry as provided herein and shall continue as such and exercise all such powers until the later of the date of confirmation of sale of the Trust Estate or the date of expiration of any redemption period unless such receivership is sooner terminated.

4.06 Remedies Not Exclusive. Trustee and Beneficiary, and each of them, shall be entitled to enforce payment and performance of any and all of the Obligations and to exercise all rights and powers under the Financing Documents and under the law now or hereafter in effect, notwithstanding some or all of the Obligations may now or hereafter be otherwise secured or guaranteed. Neither the acceptance of this Deed of Trust nor its enforcement, whether by court action or pursuant to the power of sale or other rights herein contained, shall prejudice or in any manner affect Trustee's or Beneficiary's right to realize upon or enforce any other security or guaranty now or hereafter held by Trustee or Beneficiary, it being agreed that Trustee and Beneficiary, and each of them shall be entitled to enforce this Deed of Trust and any other security or any guaranty now or hereafter held by Beneficiary or Trustee in such order and manner as they or either of them may in their absolute discretion determine. No remedy herein conferred upon or reserved to Trustee or Beneficiary is intended to be exclusive of any other

remedy herein or by law provided or permitted, but each shall be cumulative and shall be in addition to every other remedy given hereunder or now or hereafter existing under the law. Every power or remedy given by any of the Financing Documents or by law to Trustee or Beneficiary or to which either of them may be otherwise entitled, may be exercised, concurrently or independently, from time to time and as often as may be deemed expedient by Trustee or Beneficiary and, to the extent permitted by law, either of them may pursue inconsistent remedies.

4.07 Request for Notice. Trustor hereby requests a copy of any notice of default and that any notice of sale hereunder be mailed to it at the address set forth in Section 5.05.

## ARTICLE V
## MISCELLANEOUS

5.01 Change, Discharge, Termination, or Waiver. No provision of this Deed of Trust may be changed, discharged, terminated, or waived except in a writing signed by the party against whom enforcement of the change, discharge, termination, or waiver is sought. No failure on the part of Beneficiary to exercise and no delay by Beneficiary in exercising any right or remedy under the Financing Documents or under the law shall operate as a waiver thereof.

5.02 Trustor Waiver of Rights. Trustor waives, to the extent permitted by law, (a) the benefit of all laws now existing or that may hereafter be enacted providing for any appraisement before sale of any portion of the Trust Estate, and (b) all rights of redemption, valuation, appraisement, stay of execution, notice of election to mature or declare due the Obligations and marshaling in the event of foreclosure of the liens hereby created, and (c) all rights and remedies that Trustor may have or be able to assert by reason of the laws of the State of Arizona pertaining to the rights and remedies of sureties including, without limitation, A.R.S. Sections 12-1641 through 12-1646, and Arizona Rules of Civil Procedure 17(f).

5.03 Statements by Trustor. Trustor shall, within ten (10) days after written notice thereof from Beneficiary, deliver to Beneficiary a written statement stating the unpaid principal of and interest on the Notes and any other amounts secured by this Deed of Trust and stating whether any offset or defense exists against such principal and interest or such other amounts.

5.04 Reconveyance by Trustee. Upon written request of Beneficiary stating that all Obligations have been satisfied in full, and upon surrender of this Deed of Trust and the Notes to Trustee for cancellation and retention and upon payment by Trustor of Trustee's fees, Trustee shall reconvey to Trustor, or to the person or persons legally entitled thereto, without warranty, any portion of the Trust Estate then held hereunder. The recitals in such reconveyance of any matters or facts shall be conclusive proof of the truthfulness thereof. The grantee in any reconveyance may be described as "the person or persons legally entitled thereto."

5.05 Notices. All notices, requests and demands to be made hereunder to the parties hereto shall be in writing and shall be delivered by hand or sent by registered or certified mail, return receipt requested, through the United States Postal Service to the addresses shown below or such other address which the parties may provide to one another in accordance herewith. Such notices, requests and demands, if sent by mail, shall be deemed given two (2) days after

deposit in the United States mail, and if delivered by hand, shall be deemed given when delivered.

| | |
|---|---|
| To Beneficiary: | Pinnacle West Energy Corporation<br>400 North 5th Street<br>Phoenix, Arizona 85004<br>Attention: Warren Kotzmann, V. P., Finance and Corporate Services<br>Mail Station 9988 |
| To Trustor: | Arizona Public Service Company<br>400 North 5th Street<br>Phoenix, Arizona 85004<br>Attention: Don Robinson, V.P., Finance and Planning<br>Mail Station 9909 |

5.06 Acceptance by Trustee. Trustee accepts this Trust when this Deed of Trust, duly executed and acknowledged, is made a public record as provided by law.

5.07 Captions and References. The headings at the beginning of each section of this Deed of Trust are solely for convenience and are not part of this Deed of Trust. Unless otherwise indicated, each reference in this Deed of Trust to a section or an exhibit is a reference to the respective section herein or exhibit hereto.

5.08 Invalidity of Certain Provisions. If any provision of this Deed of Trust is unenforceable, the enforceability of the other provisions shall not be affected and they shall remain in full force and effect. If the lien of this Deed of Trust is invalid or unenforceable as to any part of the debt, or if the lien is invalid or unenforceable as to any part of the Trust Estate, the unsecured or partially secured portion of the debt shall be completely paid prior to the payment of the remaining and secured or partially secured portion of the debt, and all payments made on the debt, whether voluntary or under foreclosure or other enforcement action or procedure, shall be considered to have been first paid on and applied to the full payment of that portion of the debt which is not secured or fully secured by the lien of this Deed of Trust.

5.09 Subrogation. To the extent that proceeds of the Notes are used to pay any outstanding lien, charge or prior encumbrance against the Trust Estate, such proceeds have been or will be advanced by Beneficiary at Trustor's request and Beneficiary shall be subrogated to any and all rights and liens held by any owner or holder of such outstanding liens, charges and prior encumbrances, irrespective of whether said liens, charges or encumbrances are released.

5.10 Attorneys' Fees. If any or all of the Obligations are not paid when due or if an Event of Default occurs, Trustor agrees to pay all costs of enforcement and collection and preparation therefore (including, without limitation, reasonable attorney's fees) whether or not any action or proceeding is brought (including, without limitation, all such costs incurred in connection with any bankruptcy, receivership, or other court proceedings (whether at the trial or appellate level)), together with interest therein from the date of demand at the Default Rate.

5.11 Governing Law. THIS DEED OF TRUST SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF ARIZONA.

5.12 Joint and Several Obligations. If this Deed of Trust is signed by more than one party as Trustor, all obligations of Trustor herein shall be the joint and several obligations of each party executing this Deed of Trust as Trustor.

5.13 Number and Gender. In this Deed of Trust the singular shall include the plural and the masculine shall include the feminine and neuter gender and vice versa, if the context so requires.

5.14 No Merger of Lease. If both the lessor's and lessee's estate under any lease or any portion thereof which constitutes a part of the Trust Estate shall at any time become vested in one owner, this Deed of Trust and the lien created hereby shall not be destroyed or terminated by application of the doctrine of merger unless Beneficiary so elects as evidenced by recording a written declaration executed by Beneficiary so stating, and, unless and until Beneficiary so elects, Beneficiary shall continue to have and enjoy all of the rights and privileges of Beneficiary as to the separate estates. In addition, upon the foreclosure of the lien created by this Deed of Trust on the Trust Estate pursuant to the provisions hereof, any leases or subleases then existing and affecting all or any portion of the Trust Estate shall not be destroyed or terminated by application of the law of merger or as a matter of law or as a result of such foreclosure unless Beneficiary or any purchaser at such foreclosure sale shall so elect. No act by or on behalf of Beneficiary or any such purchaser shall constitute a termination of any lease or sublease unless Beneficiary or such purchaser shall give written notice thereof to such tenant or subtenant.

5.15 Status of Title. Trustor represents and warrants that it is the lawful owner of the Trust Estate free and clear of all Liens and Encumbrances and holds a fee simple estate in the Premises and Improvements, subject only to the Permitted Exceptions and that Trustor has full right, power and authority to convey and mortgage the same and to execute this Deed of Trust.

5.16 Integration. The Financing Documents contain the complete understanding and agreement of Trustor and Beneficiary and supersede all prior representations, warranties, agreements, arrangements, understandings, and negotiations.

5.17 Binding Effect. The Financing Documents will be binding upon, and inure to the benefit of, Trustor, Trustee and Beneficiary and their respective successors and assigns. Trustor may not delegate its obligations under the Financing Documents.

5.18 Time of the Essence. Time is of the essence with regard to the each provision of the Financing Documents as to which time is a factor.

5.19 Survival. The representations, warranties, and covenants of the Trustor and the Financing Documents shall survive the execution and delivery of the Financing Documents.

IN WITNESS WHEREOF, Trustor has executed this Deed of Trust as of the day and year first above written.

PINNACLE WEST ENERGY CORPORATION, an Arizona corporation

By: _____
Name: Warren Kotzmann
Title: Vice President, Finance and Corporate Services

"Trustor"

STATE OF ARIZONA )
) ss.
County of Maricopa )

The foregoing instrument was acknowledged before me this 5th day of December, 2002, by Warren Kotzmann, the Vice President, Finance and Corporate Services of PINNACLE WEST ENERGY CORPORATION, An Arizona corporation, on behalf of the corporation.

Norann Asciutto
Notary Public

My commission expires:
2/12/06

OFFICIAL SEAL
NORANN ASCIUTTO
Notary Public - State of Arizona
MARICOPA COUNTY
My comm. expires Feb. 12, 2006

EXHIBIT A

**PARCEL NO. 1:**

The North half of the Southwest quarter of Section 25, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 2:**

The south half of Section 14, Township 1 South, Range 6 West, of the Gila and Salt River Base and Meridian, Maricopa County, Arizona.

**PARCEL NO. 3:**

The Northwest quarter of Section 26, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona.

**PARCEL NO. 4:**

The East half of the East half of Section 22, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

EXCEPT that portion conveyed to the Arizona Eastern Railroad Company, by instrument recorded in Book 198 of Deeds, page 547, records of Maricopa County, Arizona; and

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 5:**

The Northwest quarter of Section 23, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

EXCEPT that portion conveyed to the Arizona Eastern Railroad Company, a corporation, by instrument recorded in Book 198 of Deeds, page 548, records of Maricopa County, Arizona;

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 6:**

The Southwest quarter of Section 23, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

EXCEPT that portion conveyed to the Arizona Eastern Railroad Company, a corporation, by instrument recorded in Book 198 of Deeds, page 548, records of Maricopa County Arizona; and

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 7:**

The Southeast quarter of Section 23, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 8:**

The Northwest quarter of Section 25, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 9:**

The North half of the Northeast quarter of Section 26, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;
Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 10:**

The Northeast quarter of Section 23, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

EXCEPT that portion conveyed to the Arizona Eastern Railroad Company, a corporation, by instrument recorded in Book 198 of Deeds, page 548, records of Maricopa County, Arizona; and

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 11:**

The Southwest quarter of the Northwest quarter, and the South half of the Southeast quarter of the Northwest quarter of Section 24, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 12:**

The West half of the Southwest quarter of the Northeast quarter, the West half of the Northwest quarter of the Southeast quarter, and the Southwest quarter of the Northwest quarter of the Northeast quarter of Section 25, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

**PARCEL NO. 13:**

The Southwest quarter of Section 24, Township 1 South, Range 6 West of the Gila and Salt River Base and Meridian, Maricopa County, Arizona;

Except all oil, gas, other hydrocarbon substances, helium or other substances of a gaseous nature, coal, metals, minerals, fossils, fertilizer of every name and description and except all uranium, thorium or any other material which is or may be determined to be peculiarly essential to the production of fissionable materials whether or not of commercial value, as set forth in Section 37-231, ARS.

EXHIBIT C

"Permitted Exceptions" means the following:

1. Sale, transfer, or other disposition of any Personal Property that is consumed or worn out in ordinary usage and that is promptly replaced with similar items of equal or greater value.

2. Any purchase, sale, transportation, exchange, option, or similar transaction in the ordinary course of Trustor's business with respect to fuel, electricity and/or capacity, including, but not limited to, system, plant or unit contingent transactions or system, plant or unit specific tolling agreements (collectively, the "Transactions"), and the assignment of such Transactions to or from the Trustor.

3. Liens and Encumbrances being contested in accordance with Section 1.17 of the Deed of Trust.

4. Impositions being contested in accordance with Section 1.07(d) of this Deed of Trust.

5. Items recorded in the Official records of the county prior to the date of recording of this Deed of Trust.

EXHIBIT B

DESCRIPTION OF PERSONAL PROPERTY

(a) All personal property, (including, without limitation, all goods, supplies, equipment, furniture, furnishings, fixtures, machinery, and inventory) in which Trustor now or hereafter acquires an interest or right, which is now or hereafter located on or affixed to the Premises or the Improvements, together with all books, records, leases and other agreements, documents, and instruments of whatever kind or character, relating to the Premises, Improvements, or such personal property;

(b) All fees, income, rents, issues, profits, earnings, receipts, royalties, and revenues which, after the date hereof and while any portion of the Obligations remains unpaid or unperformed, may accrue from the personal property referenced in Paragraph (a) above, or any part thereof or from the Premises, the Improvements or any other part of the Trust Estate, or which may be received or receivable by Trustor from any hiring, using, letting, leasing, subhiring, subletting, subleasing, occupancy, operation, or use thereof;

(c) All of Trustor's present and future rights to receive payments of money, services, or property, relating to the Premises, the Improvements, or the personal property described in Paragraph (a) above including, without limitation, rights to all deposits from tenants of the Premises or Improvements, accounts and other accounts receivable, deposit accounts, chattel paper, notes, drafts, contract rights, instruments, general intangibles, and principal, interest and payments due on account of goods sold or leased, services rendered, loans made or credit extended, together with title to or interest in all agreements, documents, and instruments, evidencing, securing or guarantying the same;

(d) All other intangible property and rights relating to the Premises, the Improvements, the personal property described in Paragraph (a) above or the operation, occupancy, or use thereof, including, without limitation, all governmental and non-governmental permits, licenses, and approvals relating to construction on or operation, occupancy, or use of the Premises or Improvements, all names under or by which the Premises or Improvements may at any time be operated or known, all rights to carry on business under any such names, or any variant thereof, all trade names and trademarks relating in any way to the Premises or the Improvements, and all good will in any way relating to the Premises or the Improvements;

(e) Trustor's rights under all insurance policies covering the Premises, the Improvements, the Personal Property, and the other parts of the Trust Estate and any and all proceeds, loss payments, and premium refunds payable regarding the same;

(f) All water stock relating to the Premises;

(g) All causes of action, claims, compensation, and recoveries for any damage to, destruction of, or condemnation or taking of the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate, or for any conveyance in lieu thereof, whether direct or consequential, or for any damage or injury to the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate, or for any loss or diminution in value of the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate;

(h) All architectural, structural, mechanical, and engineering plans and specifications prepared for construction of Improvements or extraction of minerals or gravel from the Premises and all studies, data, and drawings related thereto; and also all contracts and agreements of the Trustor relating to the aforesaid plans and specifications or to the aforesaid studies, data, and drawings or to the construction of Improvements on or extraction of minerals or gravel from the Premises;

(i) All proceeds from sale or disposition of any of the aforesaid collateral; and

(j) All Trustor's rights in proceeds of the loan evidenced by the Note.

(k) As used in this Exhibit B the terms "Premises", "Improvements", and "Personal Property" shall have the meanings set forth in the Deed of Trust to which this Exhibit B is attached.

When Recorded Return To:

Snell & Wilmer, LLP
One Arizona Center
Phoenix, Arizona 85004
Attn: David J. Carroll

Recorder's Use
(Saguaro Power Plant)

**DEED OF TRUST AND FIXTURE FILING**
**(With Assignment of Rents and Security Agreement)**
**(VARIABLE RATE)**

**THIS DEED OF TRUST SECURES VARIABLE RATE PROMISSORY NOTES.**

THIS DEED OF TRUST AND FIXTURE FILING (With Assignment of Rents and Security Agreement) (as it may be amended and modified from time to time, the "Deed of Trust") is made as of December 4, 2002, by and among **PINNACLE WEST ENERGY CORPORATION, an Arizona corporation ("Trustor")**, whose mailing address is 400 North 5th Street, Phoenix, Arizona 85004, **FIRST AMERICAN TITLE INSURANCE COMPANY, a California corporation ("Trustee")**, whose mailing address is P.O. Box 2922, Phoenix, Arizona, and **ARIZONA PUBLIC SERVICE COMPANY, an Arizona corporation, ("Beneficiary")**, whose mailing address is 400 North 5th Street, Phoenix, Arizona 85004. Capitalized terms used in this Deed of Trust not otherwise defined herein shall be as used in that certain 364-Day Credit Agreement, dated of even date herewith, by and between Beneficiary, as Lender and PINNACLE WEST CAPITAL CORPORATION, an Arizona corporation, as "Borrower" (the "Loan Agreement").

FOR GOOD AND VALUABLE CONSIDERATION, including the indebtedness herein recited and the trust herein created, the receipt of which is hereby acknowledged, Trustor hereby irrevocably grants, transfers, conveys and assigns to Trustee, IN TRUST, WITH POWER OF SALE, for the benefit and security of Beneficiary, under and subject to the terms and conditions hereinafter set forth, that certain real property located in the County of Pinal, State of Arizona, more particularly described in Exhibit A attached hereto and incorporated herein by this reference (the "Premises");

TOGETHER WITH any and all buildings and other improvements now or hereafter erected on the Premises including, without limitation, fixtures, attachments, appliances, equipment, machinery, and other personal property attached to such buildings and other improvements (the "Improvements"), all of which shall be deemed and construed to be a part of the real property;

TOGETHER WITH all rents, issues, profits, damages, royalties, income and other benefits now or hereafter derived from the Premises and the Improvements (collectively the "Rents"), subject to the terms and provisions of Article II of this Deed of Trust with respect to all leases and subleases of the Premises or Improvements now or hereafter existing or entered into,

or portions thereof, granted by Trustor, and further subject to the right, power and authority hereinafter given to Trustor to collect and apply such Rents;

TOGETHER WITH all interests, estates or other claims, both in law and in equity, which Trustor now has or may hereafter acquire in the Premises or the Improvements;

TOGETHER WITH all easements, rights-of-way and other rights now owned or hereafter acquired by Trustor used in connection with the Premises or the Improvements or as a means of access thereto (including, without limitation, all rights pursuant to any trackage agreement and all rights to the nonexclusive use of common drive entries, and all tenements, hereditaments and appurtenances thereof and thereto) and all water and water rights and shares of stock evidencing the same;

TOGETHER WITH all leasehold estate, right, title and interest of Trustor in and to all leases or subleases covering the Premises or the Improvements or any portion thereof now or hereafter existing or entered into, and all right, title and interest of Trustor thereunder including, without limitation, all rights of Trustor against guarantors thereof, all cash or security deposits, advance rentals, and deposits or payments of similar nature (collectively, the "Leases");

TOGETHER WITH all right, title and interest now owned or hereafter acquired by Trustor in and to any greater estate in the Premises or the Improvements;

TOGETHER WITH all right, title, and interest of Trustor in (i) the property and interests in property described on Exhibit B attached hereto and incorporated herein by reference, and (ii) all proceeds thereof (such personal property and proceeds are referred to herein collectively as the "Personal Property");

TOGETHER WITH all right, title and interest of Trustor, now owned or hereafter acquired, in and to any land lying within the right-of-way of any street, open or proposed, adjoining the Premises, and any and all sidewalks, alleys and strips and gores of land adjacent to or used in connection with the Premises;

TOGETHER WITH all the estate, interest, right, title, other claim or demand, both in law and in equity (including, without limitation, claims or demands with respect to the proceeds of insurance in effect with respect thereto) that Trustor now has or may hereafter acquire in the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate (as defined below), and any and all awards made for the taking by eminent domain, or by any proceeding of purchase in lieu thereof, of the whole or any part of the Trust Estate (including, without limitation, any awards resulting from a change of grade of streets and awards for severance damages);

TOGETHER WITH all proceeds of the foregoing.

The entire estate, property, right, title and interest hereby conveyed to Trustee may hereafter be collectively referred to as the "Trust Estate."

FOR THE PURPOSE OF SECURING (in such order of priority as Beneficiary may elect) the following (the "Obligations"):

(a) all obligations of Borrower to Beneficiary pursuant to the Loan Agreement in the maximum principal amount of **ONE HUNDRED TWENTY-FIVE MILLION AND NO/100 DOLLARS ($125,000,000.00)**, as more particularly evidenced by the Notes (the Loan Agreement contains a provision providing for a variable rate of interest under the Notes); and

(b) payment of all sums advanced by Beneficiary to protect the Trust Estate, with interest thereon equal to the Base Rate plus three percent (3%);

(c) performance of every obligation of Borrower and/or Trustor contained in the Financing Documents (as defined below);

(d) performance of every obligation of Trustor contained in any agreement, document, or instrument now or hereafter executed by Trustor reciting that the obligations thereunder are secured by this Deed of Trust; and

(e) for the benefit of Beneficiary, compliance with and performance of each and every provision of any declaration of covenants, conditions and restrictions, any maintenance, easement and party wall agreement, or any other agreement, document, or instrument by which the Trust Estate is bound or may be affected.

This Deed of Trust, the Notes, the Loan Agreement, and any other deeds of trust, mortgages, agreements, guaranties or other instruments given to evidence or further secure the payment and performance of any or all of the Obligations, as the foregoing may be amended, modified, extended, or renewed from time to time may hereinafter be collectively referred to as the "Financing Documents."

TRUSTOR HEREBY COVENANTS AND AGREES AS FOLLOWS:

## ARTICLE I
## COVENANTS AND AGREEMENTS OF TRUSTOR

1.01 Maintenance, Repair, Alterations. Trustor shall keep the Trust Estate in good condition and repair. Trustor shall not remove, demolish, or substantially alter any of the Improvements, except with the prior written consent of Beneficiary; provided, however, that the written consent of Beneficiary shall not be required for any removal, demolition or alterations to the Improvements resulting from Trustor's ongoing construction program or in connection with Trustor's Prudent Utility Practices. For purposes of this Deed of Trust, "Prudent Utility Practices" shall mean those nationally recognized practices, methods, standards and acts (including, but not limited to, the practices, methods, standards and acts engaged in or approved by a significant portion of the power generation industry in United States), that, in the exercise of reasonable prudent judgment in light of the facts known or that should reasonably have been known at the time a decision was made, would have been expected to accomplish the desired result consistent with good engineering practices, safety, reliability, and good business practices, and which practices, methods, standards and acts conform to a majority of the operation and maintenance standards followed by power generating plants of similar type, size and capacity as the Premises. Prudent Utility Practices are not limited to the optimum practice or method to the

exclusion of others, but rather refer to the reasonable practices and methods used by a significant portion of the power generation industry in the United States. Trustor shall complete promptly and in a good and workmanlike manner any Improvement that may be now or hereafter constructed on the Premises and promptly restore in like manner any Improvements that may be damaged or destroyed from any cause whatsoever and pay when due all claims for labor performed and materials furnished therefor. Trustor shall comply with all Requirements (as defined below) and shall not suffer to occur or exist any violation of any Requirement. Trustor shall not commit or permit any waste or deterioration of the Trust Estate, and, to the extent allowed by law, shall keep and maintain abutting grounds, sidewalks, roads, parking and landscape areas in good and neat order and repair. Trustor shall perform its obligations under each Lease. "Requirement" and "Requirements" mean, respectively, each and all obligations and requirements now or hereafter in effect by which Trustor or the Trust Estate are bound or which are otherwise applicable to the Trust Estate, construction of any Improvements on the Trust Estate, or operation, occupancy or use of the Trust Estate (including, without limitation (i) such obligations and requirements imposed by common law or any law, statute, ordinance, regulation, or rule (federal, state, or local), and (ii) such obligations and requirements of, in, or in respect of (A) any consent, authorization, license, permit, or approval relating to the Trust Estate, (B) any condition, covenant, restriction, easement, or right-of-way reservation applicable to the Trust Estate, (C) any Lien or Encumbrance, (D) any other agreement, document, or instrument to which Trustor is a party or by which Trustor or the Trust Estate is bound or affected, and (E) any order, writ, judgment, injunction, decree, determination, or award of any arbitrator, other private adjudicator, court, government, or governmental authority (federal, state, or local) to which Trustor is a party or by which Trustor or the Trust Estate is bound or affected).

1.02 Required Insurance. Trustor shall at all times provide, maintain and keep in force or cause to be provided, maintained and kept in force with respect to the Trust Estate, at no expense to Trustee or Beneficiary, policies of insurance in forms and amounts and issued by companies reasonably satisfactory to Beneficiary covering such casualties, risks, perils, liabilities and other hazards as is required under the Loan Agreement. All such policies of insurance required by the terms of this Deed of Trust or the Loan Agreement shall contain an endorsement or agreement by the insurer that any loss shall be payable in accordance with the terms of such policy notwithstanding any act or negligence of Trustor or any party holding under Trustor that might otherwise result in forfeiture of said insurance and the further agreement of the insurer waiving all rights of setoff, counterclaim or deductions against Trustor.

1.03 Delivery of Policies, Payment of Premiums.

(a) At Beneficiary's option all policies of insurance shall either have attached thereto a lender's loss payable endorsement for the benefit of Beneficiary in form satisfactory to Beneficiary or shall name Beneficiary as an additional insured. Trustor shall furnish Beneficiary with certificates of insurance for each required policy setting forth the coverage, the limits of liability, the name of the carrier, the policy number and the period of coverage. If Beneficiary consents, Trustor may provide any of the required insurance through blanket policies carried by Trustor and covering more than one location, or by policies procured by a tenant or other party holding under Trustor; provided, however, all such policies shall meet the requirements referred to in Section 1.02. At least thirty (30) days prior to the expiration of each required policy, Trustor

shall deliver to Beneficiary evidence reasonably satisfactory to Beneficiary of the payment of premium and the renewal or replacement of such policy continuing insurance in form as required by this Deed of Trust. All such policies shall contain a provision that, notwithstanding any contrary agreement between Trustor and insurance company, such policies will not be cancelled, allowed to lapse without renewal, surrendered or materially amended, which term shall include any reduction in the scope or limits of coverage, without at least thirty (30) days' prior written notice to Beneficiary.

(b) In the event Trustor fails to obtain, maintain, or deliver to Beneficiary the policies of insurance with respect to the Trust Estate required by this Deed of Trust, Beneficiary may, at Beneficiary's election, but without any obligation so to do, procure such insurance or single-interest insurance for such risks covering Beneficiary's interest, and Trustor will pay all premiums thereon promptly upon demand by Beneficiary, and until such payment is made by Trustor, the amount of all such premiums shall bear interest at the Default Rate. Upon the occurrence and during the continuation of an Event of Default and request by Beneficiary, Trustor shall deposit with Beneficiary in monthly installments, an amount equal to one-twelfth (1/12) of the estimated aggregate annual insurance premiums on all policies of insurance required by this Deed of Trust (funds deposited for this purpose are referred to as "Insurance Impounds"). In such event Trustor further agrees to cause all bills, statements, or other documents relating to the foregoing insurance premiums to be sent or mailed directly to Beneficiary. Upon receipt of such bills, statements, or other documents evidencing that a premium for a required policy is then payable, and provided there are sufficient Insurance Impounds, Beneficiary shall timely pay such amounts as may be due thereunder out of the Insurance Impounds. If at any time and for any reason the Insurance Impounds are or will be insufficient to pay such amounts as may be then or subsequently due, Beneficiary shall notify Trustor and Trustor shall immediately deposit an amount equal to such deficiency with Beneficiary. Notwithstanding the foregoing, nothing contained herein shall cause Beneficiary to be deemed a trustee of Insurance Impounds or to be obligated to pay any amounts in excess of the amount of the Insurance Impounds, nor shall anything contained herein modify the obligation of Trustor set forth in Section 1.01 to obtain and maintain insurance. Beneficiary may commingle Insurance Impounds with its own funds, and Trustor shall not be entitled to interest thereon. Beneficiary may reserve for future payments of premiums such portion of Insurance Impounds as Beneficiary in its absolute and sole discretion deems proper. If Trustor fails to deposit with Beneficiary sums sufficient to pay fully such premiums at least thirty (30) days before delinquency thereof, Beneficiary may, at Beneficiary's election, but without any obligation so to do, advance any amounts required to make up the deficiency, which advances, if any, shall be secured hereby and shall be repayable to Beneficiary upon demand with interest from the date advanced at the Default Rate, or at the option of Beneficiary the latter may, without making any advance whatever, apply any Insurance Impounds to payment of the Obligations in such order as Beneficiary may determine, notwithstanding that such Obligations may not yet be due. Upon the occurrence of an Event of Default, Beneficiary may, at any time, at Beneficiary's option, apply any Insurance Impounds or Impositions Impounds under this Section 1.03 or Section 1.07, any funds paid as Rents, and any other funds of Trustor held by Beneficiary to payment of any of the Obligations, in such manner and order as Beneficiary may elect, notwithstanding that such Obligations may not yet be due.

1.04 Casualties; Insurance Proceeds.

(a) Trustor shall give prompt written notice thereof to Beneficiary after the happening of any casualty to or in connection with the Trust Estate or any part thereof, whether or not covered by insurance. All proceeds of insurance shall be payable to Beneficiary, and Trustor hereby authorizes and directs any affected insurance company to make payment of such proceeds directly to Beneficiary. If Trustor receives any proceeds of insurance resulting from such casualty, Trustor shall promptly pay over such proceeds to Beneficiary. All proceeds of insurance will be applied by Beneficiary to payment of the Obligations in such order as Beneficiary shall determine.

(b) Trustor shall not be excused from repairing or maintaining the Trust Estate as provided in Section 1.01 hereof or restoring all damage or destruction to the Trust Estate, regardless of whether or not there are insurance proceeds available to Trustor or whether any such proceeds are sufficient in amount, and the application or release by Beneficiary of any insurance proceeds shall not cure or waive any default or notice of default under this Deed of Trust or invalidate any act done pursuant to such default or notice of default.

1.05 Assignment of Policies Upon Foreclosure. In the event of foreclosure of this Deed of Trust as a mortgage, a sale under the power of sale, or any other transfer of title or assignment of the Trust Estate in extinguishment, in whole or in part, of the Obligations, all right, title and interest of Trustor in and to all policies of insurance required by Section 1.02 shall inure to the benefit of and pass to the successor in interest to Trustor or the purchaser or grantee of the Trust Estate, to the extent such policies are assignable pursuant to the terms thereof.

1.06 Indemnification; Subrogation; Waiver of Offset.

(a) If Beneficiary is made a party to any litigation concerning the Notes, this Deed of Trust, any of the Financing Documents, the Trust Estate or any part thereof or interest therein, or the occupancy of the Trust Estate by Trustor, which litigation is not the result of a claim or counterclaim made by Trustor or Borrower against Beneficiary for breach of Beneficiary's obligations under the Financing Documents (each, an "Excluded Claim"), then Trustor shall indemnify, defend and hold Beneficiary harmless for, from and against all liability by reason of said litigation, including reasonable attorneys' fees and expenses incurred by Beneficiary as a result of any such litigation, whether or not any such litigation is prosecuted to judgment. Beneficiary may employ an attorney or attorneys to protect its rights hereunder, and in the event of such employment following any breach by Trustor, Trustor shall pay Beneficiary reasonable attorneys' fees and expenses incurred by Beneficiary, whether or not an action is actually commenced against Trustor by reason of its breach.

(b) Trustor waives any and all right to claim or recover against Beneficiary, its successors and assigns, their directors, officers, employees, agents and representatives, for loss of or damage to Trustor, the Trust Estate, Trustor's property or the property of others under Trustor's control from any cause insured against or required to be insured against by this Deed of Trust.

(c) All sums payable by Trustor pursuant to this Deed of Trust shall be paid without notice (except for such notice as may be expressly required hereunder or under the other Financing Documents), demand, counterclaim, setoff, deduction or defense and without abatement, suspension, deferment, diminution or reduction, and the obligations and liabilities of Trustor hereunder shall in no way be released, discharged or otherwise affected (except as expressly provided herein) by reason of: (i) any damage to or destruction of or any condemnation or similar taking of the Trust Estate or any part thereof; (ii) any restriction or prevention of or interference by any Person (as defined below) with any use of the Trust Estate or any part thereof; (iii) any title defect or encumbrance or any eviction from the Premises or the Improvements or any part thereof by title paramount or otherwise; or (iv) any bankruptcy, insolvency, reorganization, composition, adjustment, dissolution, liquidation or other like proceeding relating to Beneficiary, or any action taken with respect to this Deed of Trust by any trustee or receiver of Beneficiary, or by any court, in any such proceeding. Except as expressly provided herein, Trustor waives all rights now or hereafter conferred by statute or otherwise to any abatement, suspension, deferment, diminution or reduction of any sum secured hereby and payable by Trustor. "Person" means any natural person, any unincorporated association, any corporation, any partnership, any joint venture, any trust, any other legal entity, or any governmental authority (federal, state, local or foreign), excluding Beneficiary.

1.07 Impositions.

(a) Trustor shall pay, or cause to be paid, prior to delinquency, all real property taxes and assessments, general and special, and all other taxes and assessments of any kind or nature whatsoever, (including, without limitation, nongovernmental levies or assessments such as maintenance charges, levies, or charges resulting from covenants, conditions and restrictions affecting the Trust Estate) that are assessed or imposed upon the Trust Estate or become due and payable and that create, may create, or appear to create a lien upon the Trust Estate (the above are sometimes referred to herein individually as an "Imposition" and collectively as "Impositions"), provided, however, that if by law any Imposition is payable, or may at the option of the taxpayer be paid, in installments, Trustor may pay the same or cause it to be paid, together with any accrued interest on the unpaid balance of such Imposition, in installments as the same becomes due and before any fine, penalty, interest, or cost may be added thereto for the nonpayment of any such installment and interest.

(b) If at any time after the date hereof there shall be assessed or imposed a fee, tax, or assessment on Beneficiary and measured by or based in whole or in part upon this Deed of Trust or the outstanding amount of the Obligations, then all such taxes, assessments or fees shall be deemed to be included within the term "Impositions" as defined in Section 1.07(a) and Trustor shall pay and discharge the same as herein provided with respect to the payment of Impositions. If Trustor fails to pay such Impositions prior to delinquency, Beneficiary may declare all or part of the Obligations, immediately due and payable. If Trustor is prohibited by law from paying such Impositions, Beneficiary may declare all or part of the Obligations due and payable on a

date which is not less than six (6) months from the date such prohibition is imposed on Trustor.

(c) Subject to the provisions of Section 1.07(d) and upon request by Beneficiary, Trustor shall deliver to Beneficiary within thirty (30) days after the date upon which any Imposition is due and payable by Trustor official receipts of the appropriate taxing authority, or other proof satisfactory to Beneficiary, evidencing the payment thereof.

(d) Trustor shall have the right before any delinquency occurs to contest or object to the amount or validity of any Imposition by appropriate proceedings, but this shall not be deemed or construed in any way as relieving, modifying, or extending Trustor's covenant to pay any such Imposition at the time and in the manner provided in this Section 1.07, unless Trustor has given prior written notice to Beneficiary of Trustor's intent to so contest or object to an Imposition, and unless, in Beneficiary's absolute and sole discretion, (i) Trustor shall demonstrate to Beneficiary's satisfaction that the proceedings to be initiated by Trustor shall conclusively operate to prevent the sale of the Trust Estate or any part thereof or interest therein to satisfy such Imposition prior to final determination of such proceedings, (ii) Trustor shall furnish a good and sufficient bond or surety as requested by and satisfactory to Beneficiary, or (iii) Trustor shall demonstrate to Beneficiary's satisfaction that Trustor has provided a good and sufficient undertaking as may be required or permitted by law to accomplish a stay of any such sale.

(e) Upon the occurrence and during the continuation of an Event of Default and upon request by Beneficiary, Trustor shall pay to Beneficiary an initial cash deposit in an amount adequate to pay all Impositions for the ensuing tax fiscal year and shall thereafter continue to deposit with Beneficiary, in monthly installments, an amount equal to one-twelfth (1/12) of the sum of the annual Impositions reasonably estimated by Beneficiary, for the purpose of paying the installment of Impositions next due (funds deposited for this purpose are referred to as "Impositions Impounds"). In such event, Trustor further agrees to cause all bills, statements, or other documents relating to Impositions to be sent or mailed directly to Beneficiary. Upon receipt of such bills, statements, or other documents, and providing there are sufficient Impositions Impounds, Beneficiary shall timely pay such amounts as may be due thereunder out of the Impositions Impounds. If at any time and for any reason the Impositions Impounds are or will be insufficient to pay such amounts as may then or subsequently be due, Beneficiary may notify Trustor and upon such notice Trustor shall deposit immediately an amount equal to such deficiency with Beneficiary. Notwithstanding the foregoing, nothing contained herein shall cause Beneficiary to be deemed a trustee of Impositions Impounds or to be obligated to pay any amounts in excess of the amount of funds deposited with Beneficiary pursuant to this Section 1.07(e). Beneficiary may commingle Impositions Impounds with its own funds and shall not be obligated to pay any interest on any Impositions Impounds. Beneficiary may reserve for future payment of Impositions such portion of Impositions Impounds as Beneficiary may in its absolute and sole discretion deem proper. If Trustor fails to deposit with Beneficiary sums sufficient to fully pay such Impositions at least thirty (30) days before delinquency thereof, Beneficiary may, at Beneficiary's election, but without any obligation so to do, advance any amounts required

to make up the deficiency, which advances, if any, shall be secured hereby and shall be repayable to Beneficiary upon demand together with interest thereon at the Default Rate from the date of such advance, or at the option of Beneficiary the latter may, without making any advance whatever, apply any Impositions Impounds held by it upon any of the Obligations in such order as Beneficiary may determine, notwithstanding that such Obligations may not yet be due.

(f) Trustor shall not initiate or suffer to occur or exist the joint assessment of any real and personal property included in the Trust Estate or any other procedure whereby the lien of real property taxes and the lien of personal property taxes shall be assessed, levied, or charged to the Trust Estate as a single lien.

1.08 Utilities. Trustor shall pay when due all charges that are incurred by Trustor for the benefit of the Trust Estate or that may become a charge or lien against the Trust Estate for gas, electricity, water, sewer, or other services furnished to the Trust Estate.

1.09 Actions Affecting Trust Estate. Except for Excluded Claims, Trustor shall appear in and contest any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee; and shall pay all costs and expenses (including, without limitation, costs of evidence of title, litigation, and attorneys' fees) in any such action or proceeding in which Beneficiary or Trustee may appear.

1.10 Actions By Trustee or Beneficiary. If either Borrower or Trustor fails to make any payment or to do any act as and in the manner provided in any of the Financing Documents, Beneficiary and/or Trustee, each in its absolute and sole discretion, without obligation so to do, without releasing Trustor from any obligation, and with only such notice to or demand upon Trustor as may be reasonable under the then existing circumstances, but in no event exceeding ten (10) days prior written notice, may make or do the same in such manner and to such extent as either may deem necessary or appropriate. In connection therewith (without limiting their general powers, whether conferred herein, in another Financing Document or by law), Beneficiary and Trustee shall have and are hereby given the right, but not the obligation, (a) to enter upon and take possession of the Trust Estate; (b) to make additions, alterations, repairs and improvements to the Trust Estate that they or either of them may consider necessary or appropriate to keep the Trust Estate in good condition and repair; (c) to appear and participate in any action or proceeding affecting or which may affect the security hereof or the rights or powers of Beneficiary or Trustee; (d) to pay, purchase, contest or compromise any Lien or Encumbrance (as defined below) or alleged Lien or Encumbrance whether superior or junior to this Deed of Trust; and (e) in exercising such powers, to pay necessary expenses (including, without limitation, expenses of employment of counsel or other necessary or desirable consultants). Trustor shall, immediately upon demand therefor by Beneficiary and Trustee or either of them, pay to Beneficiary and Trustee an amount equal to all respective costs and expenses incurred by them in connection with the exercise by either Beneficiary or Trustee or both of the foregoing rights (including, without limitation, costs of evidence of title, court costs, appraisals, surveys and receiver's, trustee's and attorneys' fees) together with interest thereon from the date of such expenditures at the Default Rate.

1.11 Transfer of Trust Estate by Trustor. Trustor agrees that, in the event of any Transfer (as hereinafter defined), without the prior written consent of Beneficiary, Beneficiary shall have the absolute right, without prior demand or notice, to declare all sums secured hereby immediately due and payable. Consent to one such transaction shall not be deemed to be a waiver of the right to require consent to future or successive transactions. Beneficiary may grant or deny such consent in its sole discretion and, if consent should be given, any such Transfer shall be subject to this Deed of Trust, and such transferee shall assume all obligations hereunder and agree to be bound by all provisions contained herein. Such assumption shall not, however, release Trustor or any maker or guarantor (if any) of the Notes from any liability thereunder without the prior written consent of Beneficiary. As used herein, "Transfer" shall mean:

(i) any sale, transfer, conveyance, hypothecation, encumbrance, lease or vesting of the Trust Estate or any part thereof or interest therein to or in any Person, whether voluntary, involuntary, by operation of law, or otherwise, except the Permitted Exceptions (as such term is defined in Exhibit C attached hereto and incorporated herein by reference);

(ii) any sale, transfer, assignment, conveyance, hypothecation, encumbrance or vesting of any shares of stock in Trustor to or in any Person or any consolidation or merger of Trustor into or with any Person whether voluntary, involuntary, by operation of law, or otherwise, except the Permitted Exceptions; or

(iii) the execution of any agreements to do any of the foregoing, except the Permitted Exceptions;

provided, however, that the term "Transfer" shall not include the transfer by Borrower of the capital stock of Trustor, so long as (a) such transfers are made either: (1) to entities that are controlled by, controlling or under common control with Trustor and Borrower, or (2) to other persons, provided that after giving effect to such transfers pursuant to this clause (a)(2) Borrower continues to own (free and clear of Liens and Encumbrances) at least a 51% interest in Trustor and (b) such transfers do not result in the dissolution or winding up of Trustor.

1.12 Eminent Domain.

(a) In the event that any proceeding or action be commenced for the taking of the Trust Estate, or any part thereof or interest therein, for public or quasi-public use under the power of eminent domain, condemnation (including, without limitation, inverse condemnation) or otherwise (hereinafter collectively referred to as a "Taking"), or if the same be taken or damaged by reason of any public improvement or Taking, or should Trustor receive any notice or other information regarding such Taking or damage, Trustor shall give prompt written notice thereof to Beneficiary. All compensation, awards, damages, rights of action and proceeds awarded to Trustor by reason of any such Taking or damage or received by Trustor as the result of a transfer in lieu of a Taking (the "Condemnation Proceeds") are hereby assigned to Beneficiary, and Trustor agrees to execute such further assignments of the Condemnation Proceeds as Beneficiary or Trustee may require. If Trustor receives any Condemnation Proceeds Trustor shall

promptly pay over such proceeds to Beneficiary. Beneficiary is hereby authorized and empowered by Trustor, at Beneficiary's option and in Beneficiary's sole discretion, as attorney-in-fact for Trustor, to settle, adjust, or compromise any claim for loss or damage in connection with any Taking or proposed Taking and, without regard to the adequacy of its security, to commence, appear in and prosecute in its own name and/or on behalf of Trustor any such action or proceeding arising out of or relating to a Taking or proposed Taking.

(b) Trustor shall not be excused from repairing or maintaining the Trust Estate as provided in Section 1.01 or restoring all damage or destruction to the Trust Estate, regardless of whether or not there are Condemnation Proceeds available to Trustor or whether any such Condemnation Proceeds are sufficient in amount. The application or release of the Condemnation Proceeds shall not cure or waive any default or notice of default hereunder or under any other Financing Document or invalidate any act done pursuant to such default or notice of default.

1.13 Additional Security. No other security now existing, or hereafter taken, to secure the obligations secured hereby shall be impaired or affected by the execution of this Deed of Trust. All security for the Obligations from time to time shall be taken, considered and held as cumulative. Any taking of additional security, execution of partial releases of the security, or any extension of the time of payment of, or modification of other terms of any of the Obligations shall not diminish the force, effect or lien of this Deed of Trust and shall not affect or impair the liability of any maker, guarantor, surety or endorser for the payment or performance of any of the Obligations. In the event Beneficiary at any time holds additional security for any of the Obligations, it may enforce the sale thereof or otherwise realize upon the same, at its option, either before, concurrently with, or after a sale or realization is made hereunder.

1.14 Appointment of Successor Trustee. Beneficiary may, from time to time, by a written instrument executed and acknowledged by Beneficiary, mailed to Trustor and recorded in the county in which the Trust Estate is located and by otherwise complying with the provisions of applicable law, substitute a successor or successors to any Trustee named herein or acting hereunder, and such successor(s) shall, without conveyance from the Trustee predecessor, succeed to all title, estate, rights, powers and duties of such predecessor.

1.15 Inspections. Beneficiary, and its agents, representatives officers, and employees, are authorized to enter at any reasonable time upon or in any part of the Trust Estate for the purpose of inspecting the same and for the purpose of performing any of the acts Beneficiary is authorized to perform hereunder or under the terms of any of the Financing Documents.

1.16 Ownership and Liens and Encumbrances. Trustor is, and as to any portion of the Trust Estate acquired hereafter will upon such acquisitions be, and shall remain the owner of the Trust Estate free and clear of any Liens and Encumbrances. Trustor shall not grant, shall not suffer to exist, and shall pay and promptly discharge, at Trustor's cost and expense, all Liens and Encumbrances and any claims thereof upon the Trust Estate, or any part thereof or interest therein. Trustor shall notify Beneficiary immediately in writing of any Lien or Encumbrance or claim thereof. Trustor shall have the right to contest in good faith the validity of any involuntary Lien or Encumbrance, provided Trustor shall first deposit with Beneficiary a bond or other

security satisfactory to Beneficiary in such amount as Beneficiary shall reasonably require, but not more than one hundred fifty percent (150%) of the amount of the claim, and provided further that if Trustor loses such contest, Trustor shall thereafter diligently proceed to cause such Lien or Encumbrance to be removed and discharged. If Trustor shall fail to remove and discharge any Lien or Encumbrance or claim thereof, then, in addition to any other right or remedy of Beneficiary, Beneficiary may, after only such notice to Trustor as may be reasonable under the then existing circumstances, but shall not be obligated to, discharge the same, either by paying the amount claimed to be due, or by procuring the discharge of such Lien or Encumbrance by depositing in a court a bond or the amount claimed or otherwise giving security for such claim, or by procuring such discharge in such manner as is or may be prescribed by law. Trustor shall, immediately upon demand therefor by Beneficiary, pay to Beneficiary an amount equal to all costs and expenses incurred by Beneficiary in connection with the exercise by Beneficiary of the foregoing right to discharge any Lien or Encumbrance or claim thereof, together with interest thereon from the date of each such expenditure at the Default Rate. Such costs and expenses shall be secured by this Deed of Trust. "Lien or Encumbrance" and "Liens and Encumbrances" mean, respectively, each and all of the following in respect of the Trust Estate: leases, other rights to occupy or use, mortgages, deeds of trust, pledges, security agreements, assignments, assignments as security, conditional sales, title retention arrangements or agreements, conditions, covenants, and restrictions, and other charges, liens, encumbrances, or adverse interests, whether voluntarily or involuntarily created and regardless of whether prior or subordinate to any estate, right, title, or interest granted to Trustee or Beneficiary in this Deed of Trust, excluding from the foregoing the Permitted Exceptions.

1.17 Trustee's Powers. At any time, or from time to time, without liability therefor and without notice, upon written request of Beneficiary and presentation of this Deed of Trust and without affecting the personal liability of any person for payment of the Obligations or the effect of this Deed of Trust upon the remainder of said Trust Estate, Trustee may (a) reconvey any part of said Trust Estate, (b) consent in writing to the making of any map or plat thereof, (c) join in granting any easement thereon, or (d) join in any extension agreement or any agreement subordinating the lien or charge hereof.

1.18 Beneficiary's Powers. Without affecting the liability of any Person liable for the payment of the Obligations herein mentioned, and without affecting the lien or charge of this Deed of Trust upon any portion of the Trust Estate not then or theretofore released as security for the Obligations, Beneficiary may, from time to time and without notice (a) release any person so liable, (b) extend the Obligations, (c) grant other indulgences, (d) release or reconvey, or cause to be released or reconveyed, at any time at Beneficiary's option any parcel, portion or all of the Trust Estate, (e) take or release any other or additional security or any guaranty for any Obligation herein mentioned, or (f) make compositions or other arrangements with debtors in relation thereto.

1.19 Trade Names. At the request of Beneficiary from time to time, Trustor shall execute a certificate in form satisfactory to Beneficiary listing the trade names or fictitious business names under which Trustor intends to operate the Trust Estate or any business located thereon and representing and warranting that Trustor does business under no other trade names or fictitious business names with respect to the Trust Estate. Trustor shall immediately notify Beneficiary in writing of any change in said trade names or fictitious business names, and will,

upon request of Beneficiary, execute any additional financing statements and other certificates necessary to reflect the change in trade names or fictitious business names.

1.20 Leasehold. If a leasehold estate constitutes a portion of the Trust Estate, Trustor agrees not to amend, modify, extend, renew or terminate such leasehold estate, any interest therein, or the lease granting such leasehold estate without the prior written consent of Beneficiary, which consent may be withheld by Beneficiary in its absolute and sole discretion. Consent to one amendment, modification, extension or renewal shall not be deemed to be a waiver of the right to require consent to other, future or successive amendments, modifications, extensions or renewals. Trustor agrees to perform all obligations and agreements under said leasehold and shall not take any action or omit to take any action which would effect or permit the termination of said leasehold. Trustor agrees to promptly notify Beneficiary in writing with respect to any default or alleged default by any party thereto and to deliver to Beneficiary copies of all notices, demands, complaints or other communications received or given by Trustor with respect to any such default or alleged default. Beneficiary shall have the option to cure any such default and to perform any or all of Trustor's obligations thereunder. All sums expended by Beneficiary in curing any such default shall be secured hereby and shall be immediately due and payable without demand or notice and shall bear interest from date of expenditure at the Default Rate.

1.21 Environmental Matters. Trustor shall not use, generate, manufacture, store or dispose of, in, under or about the Trust Estate or transport to or from the Trust Estate any Hazardous Materials, except for those Hazardous Materials used, generated, manufactured, stored or disposed of in material compliance with all applicable Environmental Laws. For purposes of this Deed of Trust, "Environmental Laws" shall mean all federal, state or local laws, whether common law, statute, ordinance, rule, regulation, or judicial or administrative decision or policy or guideline, pertaining to Hazardous Materials, health, industrial hygiene, environmental conditions, or the regulation or protection of the environment, and all amendments thereto as of this date and to be added in the future and any successor statute or rule or regulation promulgated thereto. For purposes of this Deed of Trust, "Hazardous Materials" shall include, but shall not be limited to (i) flammable explosives, radioactive materials, hazardous wastes, toxic substances or related materials, (ii) all substances defined as "hazardous substances," "hazardous materials," or "toxic substances" in the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended, 42 U.S.C. §9601, et seq.; the Hazardous Materials Transportation Act, 49 U.S.C. §1901, et seq.; the Resource Conservation and Recovery Act, 42 U.S.C. §6901, et seq.; and (iii) all substances defined as "hazardous substances" in Arizona Revised Statutes §49-201 (16). Except for the use, generation, storage, release, threatened release, discharge, or disposal of Hazardous Materials on, under or about the Trust Estate attributable to (a) Beneficiary's prior ownership of the Trust Estate, (b) Beneficiary's operation of the Trust Estate or (c) Beneficiary's operations on property adjacent to the Trust Estate, Trustor shall be solely responsible for, and shall indemnify and hold harmless Beneficiary, its directors, officers, employees, agents, successors and assigns from and against, any loss, damage, cost, expense or liability directly or indirectly arising out of or attributable to the use, generation, storage, release, threatened release, discharge, disposal, or presence of Hazardous Materials on, under or about the Trust Estate, including without limitation: (1) all foreseeable consequential damage; (2) the costs of any required or necessary repairs, cleanup or detoxification of the Trust Estate, and the preparation and implementation of any closure,

remedial or other required plans; and (3) all reasonable costs and expenses incurred by Beneficiary in connection with clauses (1) and (2), including but not limited to reasonable attorneys' fees. Beneficiary, or its agents, shall have the right to enter onto the Trust Estate to inspect the Premises and to perform any testing of the Trust Estate for the existence of Hazardous Materials and to determine compliance with all environmental laws. Any such inspection by Beneficiary shall not relieve Trustor of its obligations to comply with any such environmental law, rule or regulation.

1.22 Rights of Beneficiary. With respect to the Obligations, Trustor authorizes Beneficiary to perform any or all of the following acts at any time in its sole discretion, all without notice to or the consent or approval of Trustor and without affecting Trustor's obligations under this Deed of Trust:

(a) Beneficiary may alter any Obligation, including renewing, compromising, extending or accelerating, or otherwise changing the time for payment of, or increasing or decreasing the rate of interest on, all or any part of any Obligation.

(b) Beneficiary may take and hold security for any Obligation, accept additional or substituted security therefor, and subordinate, exchange, enforce, waive, release, compromise, fail to perfect, and sell or otherwise dispose of any such security.

(c) Beneficiary may direct the order and manner of any public or private sale of all or any part of any security assigned to Beneficiary by Borrower or any other person, or otherwise to comply with the Uniform Commercial Code of Arizona with respect to any personal property collateral, and Beneficiary may also bid at any such sale.

(d) Beneficiary may apply any payments or recoveries from Borrower, any guarantor (a "Guarantor") of any Obligation or any other source, and any proceeds of any security, to the Obligations in such manner, order and priority as Beneficiary may elect, whether or not those obligations are secured at the time of the application.

(e) Beneficiary may release Borrower or any other person of its liability for all or any part of any Obligation.

(f) Beneficiary may substitute, add, or release any one or more Guarantors or endorsers.

(g) In addition to the Obligations, Beneficiary may extend other credit to Borrower, and may take and hold security for the credit so extended, all without affecting Trustor's liability under this Deed of Trust.

1.23 Trustor's Waivers. Trustor waives:

(a) Any right it may have to require Beneficiary to proceed against Borrower or any other person, proceed against or exhaust any security held from Borrower or any other person, or pursue any other remedy in Beneficiary's power to pursue;

(b) Any defense based on any claim that Trustor's obligations exceed or are more burdensome than those of Borrower;

(c) Any defense based on (i) any legal disability of Borrower or any other Person, (ii) any release, discharge, modification, impairment, or limitation of the liability of Borrower or any other person to Beneficiary from any cause, whether consented to by Beneficiary or arising by operation of law or from any bankruptcy or other voluntary or involuntary proceeding, in or out of court, for the adjustment of debtor-creditor relationships ("Insolvency Proceeding"), and (iii) any rejection or disaffirmance of all or any part of any Obligation, or any security therefor, in any such Insolvency Proceeding;

(d) Any defense based on any action taken or omitted by Beneficiary in any Insolvency Proceeding involving Borrower, including any election to have Beneficiary's claim allowed as being secured, partially secured or unsecured, any extension of credit by Beneficiary to Borrower in any Insolvency Proceeding, and the taking and holding by Beneficiary of any security for any such extension of credit;

(e) All presentments, demands for performance, notices of nonperformance, protests, notices of protest, notices of dishonor, and of the existence, creation, or incurring of new or additional indebtedness, and demands and notices of every kind;

(f) Any defense based on or arising out of any defense that Borrower may have to the payment or performance of all or any part of any Obligation;

(g) Any defense based on the unenforceability or invalidity of any collateral assignment or guaranty with respect to any Obligation, or the lack of perfection or continuing perfection or lack of priority of any lien (other than the lien of this Deed of Trust) which secures any Obligation; and

(h) Any failure of Beneficiary to marshal assets in favor of Trustor or any other person.

1.24 Information Regarding Borrower and the Property. Trustor warrants and agrees that Trustor has not relied, and will not rely, on any representations and warranties by Beneficiary to Trustor with respect to the creditworthiness of Borrower or the prospects of repayment of any Obligation from sources other than the Trust Estate. Before signing this Deed of Trust, Trustor will have investigated the financial condition and business operations of Borrower, the present and former condition, uses and ownership of the Trust Estate, and such other matters as Trustor may deem appropriate to assure itself of Borrower's ability to discharge its obligations under or with respect to the Obligations. Trustor assumes full responsibility for such due diligence, as well as for keeping informed of all matters which may affect Borrower's ability to pay and perform its obligations to Beneficiary. Beneficiary has no duty to disclose to Trustor any information which Beneficiary may have or receive about Borrower's financial condition or business operations, the condition or uses of any of the Trust Estate, or any other circumstances bearing on Borrower's ability to perform. Trustor is familiar with the terms and conditions of the Loan Documents and consents to all provisions thereof.

1.25 Subordination. Any rights of Trustor, whether now existing or later arising, to receive payment on account of any indebtedness (including interest) owed to it by Borrower or any subsequent owner of any of the Trust Estate, or to withdraw capital invested by it in Borrower (if applicable), or to receive distributions from Borrower (if applicable), shall at all times be subordinate as to lien and time of payment and in all other respects to the full and prior repayment to Beneficiary of all Obligations; provided, however, that prior to the occurrence of an Event of Default, Trustor may receive payments of such subordinated obligations in the ordinary course of business and in a manner that is consistent with past practices.

1.26 Consideration.

(a) Trustor acknowledges that it expects to benefit from Beneficiary's entering into certain material transactions with respect to the Obligations because of Trustor's relationship to Borrower, and that it is executing this Deed of Trust in consideration of such anticipated benefit.

(b) Trustor does not intend to defraud any of its creditors by execution and delivery of this Deed of Trust. Trustor is not insolvent, and Trustor shall not be rendered insolvent by virtue of such execution of this Deed of Trust. Trustor has determined that, in its opinion, the fair market value of the benefits to be derived by it from such execution of this Deed of Trust will equal or exceed the cost and expense that may be incurred by Trustor under or in connection with this Deed of Trust.

1.27 Lawfulness and Reasonableness. Trustor warrants that all of the waivers in this Deed of Trust are made with full knowledge of their significance, and of the fact that events giving rise to any defense or other benefit waived by Trustor may destroy or impair rights which Trustor would otherwise have against Beneficiary, Borrower and other persons, or against collateral. Trustor agrees that (i) all such waivers are reasonable under the circumstances and (ii) if any such waiver is determined (by a court of competent jurisdiction) to be contrary to any law or public policy, the other waivers herein shall nonetheless remain in full force and effect.

1.28 Limitation on Amount Obligated; Contribution by Other Persons. Anything contained in this Deed of Trust to the contrary notwithstanding, if any Fraudulent Transfer Law (as hereinafter defined) is determined by a court of competent jurisdiction to be applicable to the obligations of Trustor under this Deed of Trust, such obligations shall be limited to a maximum aggregate amount equal to the largest amount that would not render Trustor's obligations under this Deed of Trust subject to avoidance as a fraudulent transfer or conveyance under Section 548 of Title 11 of the United States Code or any applicable provisions of comparable state law (collectively, the "Fraudulent Transfer Laws"), in each case after giving effect to all other liabilities of Trustor, contingent or otherwise, that are relevant under the Fraudulent Transfer Laws (specifically excluding, however, any liabilities of Trustor in respect of intercompany indebtedness, if any, to Borrower or any Affiliate (as defined in the Loan Agreement) of Borrower to the extent that such indebtedness would be discharged in an amount equal to the amount paid by Trustor under this Deed of Trust pursuant to which the liability of Trustor under this Deed of Trust is included in the liabilities taken into account in determining such maximum amount) and after giving effect as assets to the value (as determined under the applicable provisions of the Fraudulent Transfer Laws) of any rights to subrogation, reimbursement,

indemnification, or contribution of Trustor pursuant to applicable law or pursuant to the terms of any agreement.

1.29 Enforceability. Trustor hereby acknowledges that (i) the obligations undertaken by Trustor in this Deed of Trust are complex in nature, (ii) numerous possible defenses to the enforceability of these obligations may presently exist and/or may arise hereafter, (iii) as part of Beneficiary's consideration for accepting this Deed of Trust as security for advances to be made with respect to the Loan, Beneficiary has specifically bargained for the waiver and relinquishment by Trustor of all such defenses, and (iv) Trustor has had the opportunity to seek and receive legal advice from skilled legal counsel in the area of financial transactions of the type contemplated herein. Given all of the above, Trustor hereby represents and confirms to Beneficiary that Trustor is fully informed regarding, and that Trustor does thoroughly understand, (w) the nature of all such possible defenses, (x) the circumstances under which such defenses may arise, (y) the benefits which such defenses might confer upon Trustor, and (z) the legal consequences to Trustor of waiving such defenses. Trustor acknowledges that Trustor enters into this Deed of Trust with the intent that this Deed of Trust and all of the informed waivers in this Deed of Trust shall each and all be fully enforceable by Beneficiary, and that Beneficiary is accepting this Deed of Trust in material reliance upon the presumed full enforceability thereof.

1.30 No Personal Obligation. Beneficiary agrees that (i) Trustor shall have no personal liability with respect to the Obligations and (ii) Beneficiary's recourse against Trustor for the Obligations shall be limited to Beneficiary's enforcement of its remedies against the Trust Estate as encumbered by this Deed of Trust.

## ARTICLE II
## ASSIGNMENT OF RENTS

2.01 Assignment of Rents. Trustor hereby absolutely and irrevocably assigns and transfers to Beneficiary all the Rents of the Trust Estate, and hereby gives to and confers upon Beneficiary the right, power and authority to collect the Rents. Trustor irrevocably appoints Beneficiary its true and lawful attorney-in-fact, at the option of Beneficiary at any time and from time to time, to demand, receive and enforce payment, to give receipts, releases and satisfactions, and to sue, in the name of Trustor or Beneficiary, for all Rents and apply the same to the payment of the Obligations in such order as Beneficiary shall determine. Trustor hereby authorizes and directs the lessees, tenants and occupants to make all payments under the Leases directly to Beneficiary upon written demand by Beneficiary, without further consent of Trustor; provided, however, that Trustor shall have the right to collect such Rents (but not more than one (1) month in advance unless the written approval of Beneficiary is first obtained), and to retain and enjoy same, so long as an Event of Default shall not have occurred hereunder or under the other Financing Documents. The assignment of the Rents of the Trust Estate in this Article II is intended to be an absolute assignment from Trustor to Beneficiary and not merely the passing of a security interest.

2.02 Collection Upon an Event of Default. Upon the occurrence of an Event of Default, Beneficiary may, at any time without notice, either in person, by agent or by a receiver appointed by a court, and without regard to the adequacy of any security for the Obligations, enter upon and take possession of the Trust Estate, or any part thereof, and, with or without such entry or taking possession, in its own name sue for or otherwise collect the Rents (including, without limitation, those past due and unpaid) and apply the same, less costs and expenses of operation and collection (including, without limitation, attorneys' fees) upon payment of the Obligations in such order as Beneficiary may determine. The collection of such Rents, or the entering upon and taking possession of the Trust Estate, or the application of the Rents as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done in response to such default or pursuant to such notice of default. Trustor also hereby authorizes Beneficiary upon such entry, at its option, to take over and assume the management, operation and maintenance of the Trust Estate and to perform all acts Beneficiary in its sole discretion deems necessary and proper and to expend such sums out of Rents as may be needed in connection therewith, in the same manner and to the same extent as Trustor theretofore could do (including, without limitation, the right to enter into new leases, to cancel, surrender, alter or amend the terms of, and/or renew existing leases and/or to make concessions to tenants). Trustor hereby releases all claims of any kind or nature against Beneficiary arising out of such management, operation and maintenance, excepting the liability of Beneficiary to account as hereinafter set forth.

2.03 Application of Rents. Upon such entry, Beneficiary shall, after payment of all property charges and expenses (including, without limitation, reasonable compensation to such managing agent as it may select and employ) and after the accumulation of a reserve to meet requisite amounts, credit the net amount of the Rents received by it to the Obligations, but the manner of the application of such net income and which items shall be credited shall be determined in the sole discretion of Beneficiary. Beneficiary shall not be accountable for more monies than it actually receives from the Trust Estate; nor shall it be liable for failure to collect Rents. Beneficiary shall make reasonable efforts to collect Rents, reserving, however, within its own absolute and sole discretion, the right to determine the method of collection and the extent to which enforcement of collection of Rents shall be prosecuted and Beneficiary's judgment shall be deemed conclusive and reasonable.

2.04 Mortgagee in Possession. It is not the intention of the parties hereto that an entry by Beneficiary upon the Premises under the terms of this instrument shall make Beneficiary a party in possession in contemplation of the law, except at the option of Beneficiary.

2.05 Indemnity. Except for those losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs, and expenses resulting from Beneficiary's gross negligence or willful misconduct, Trustor hereby agrees to indemnify and hold harmless Beneficiary for, from and against any and all losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs, and expenses, including legal fees and expenses, howsoever and by whomsoever asserted, arising out of or in any way connected with this assignment; and all such losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs and expenses shall be deemed added to the indebtedness secured hereby and shall be secured by any and all other instruments securing said indebtedness.

2.06 No Obligation to Perform. Nothing contained herein shall operate or be construed to obligate Beneficiary to perform any obligations of Trustor under any Lease (including, without limitation, any obligation arising out of any covenant of quiet enjoyment therein contained in the event the lessee under any such Lease shall have been joined as a party defendant in any action to foreclose and the estate of such lessee shall have been thereby terminated). Prior to actual entry into and taking possession of the Premises by Beneficiary, this assignment shall not operate to place upon Beneficiary any responsibility for the operation, control, care, management or repair of the Trust Estate or any portion thereof, and the execution of this assignment by Trustor shall constitute conclusive evidence that all responsibility for the operation, control, care, management and repair of the Trust Estate is and shall be that of Trustor, prior to such actual entry and taking of possession.

## ARTICLE III
## SECURITY AGREEMENT

3.01 Creation of Security Interest. Trustor hereby grants to Beneficiary, a security interest in and to all the Personal Property.

3.02 Representations, Warranties and Covenants of Trustor. Trustor hereby represents, warrants and covenants (which representations, warranties and covenants shall survive creation of any indebtedness of Trustor to Beneficiary and any extension of credit thereunder) as follows:

(a) The Personal Property is not used or bought for personal, family or household purposes.

(b) The tangible portion of the Personal Property will be kept on or at the Premises or Improvements and Trustor will not, without the prior written consent of Beneficiary, remove the Personal Property or any portion thereof therefrom except such portions or items of Personal Property which are consumed or worn out in ordinary usage, all of which shall be promptly replaced by Trustor with similar items of equal to or greater value.

(c) Trustor hereby authorizes Beneficiary to file and/or record financing statements and fixture filings pursuant to the Uniform Commercial Code of Arizona as in effect in the State of Arizona (Arizona Revised Statutes ("A.R.S.") Sections 47-1101 through 47-11107, as amended from time to time ("Uniform Commercial Code of Arizona")), in form satisfactory to Beneficiary and will pay the cost of recording and filing the same in all public offices wherever recording or filing is deemed by Beneficiary to be necessary or desirable.

(d) Trustor's principal place of business is in the State of Arizona at 400 North 5th Street, Phoenix, Arizona 85004. Trustor does not do business under any trade name except as previously disclosed in writing to Beneficiary. Trustor will immediately notify Beneficiary in writing of any change in its place of business or the adoption or change of any trade name or fictitious business name, and will upon request of Beneficiary, execute any additional financing statements or other certificates necessary to reflect the adoption or change in trade name or fictitious business name.

(e) Trustor shall immediately notify Beneficiary of any claim against the Personal Property adverse to the interest of Beneficiary therein.

3.03 Use of Personal Property by Trustor. Until the occurrence of an Event of Default hereunder or under any other Financing Document, Trustor may have possession of the Personal Property and use it in any lawful manner not inconsistent with this Deed of Trust and not inconsistent with any policy of insurance thereon.

3.04 Remedies Upon an Event of Default.

(a) In addition to the remedies provided in Section 4.02 hereof, upon the occurrence of an Event of Default hereunder, Beneficiary may do any one or more of the following:

(i) Either personally, or by means of a court appointed receiver, take possession of all or any of the Personal Property and exclude therefrom Trustor and all others claiming under Trustor, and thereafter hold, store, use, operate, manage, maintain and control, make repairs, replacements, alterations, additions and improvements to and exercise all rights and powers of Trustor with respect to the Personal Property or any part thereof. In the event Beneficiary demands, or attempts to take possession of the Personal Property in the exercise of any rights under this Deed of Trust, Trustor agrees to promptly turn over and deliver possession thereof to Beneficiary;

(ii) Without notice to or demand upon Trustor, make such payments and do such acts as Beneficiary may deem necessary to protect its security interest in the Personal Property (including, without limitation, paying, purchasing, contesting or compromising any Lien or Encumbrance, whether superior or inferior to such security interest) and in exercising any such powers or authority to pay all expenses (including, without limitation, litigation costs and reasonable attorney's fees) incurred in connection therewith;

(iii) Require Trustor from time to time to assemble the Personal Property, or any portion thereof, at a place designated by Beneficiary and reasonably convenient to both parties, and deliver promptly such Personal Property to Beneficiary, or an agent or representative designated by Beneficiary. Beneficiary, and its agents and representatives, shall have the right to enter upon any or all of Trustor's premises and property to exercise Beneficiary's rights hereunder;

(iv) Realize upon the Personal Property or any part thereof as herein provided or in any manner permitted by law and exercise any and all of the other rights and remedies conferred upon Beneficiary by this Deed of Trust, any other Financing Document, or by law, either concurrently or in such order as Beneficiary may determine;

(v) Sell or cause to be sold in such order as Beneficiary may determine, as a whole or in such parcels as Beneficiary may determine, the Personal Property and the remainder of the Trust Estate;

(vi) Sell, lease, or otherwise dispose of the Personal Property at public sale, upon terms and in such manner as Beneficiary may determine. Beneficiary may be a purchaser at any sale; and

(vii) Exercise any remedies of a secured party under the Uniform Commercial Code of Arizona or any other applicable law.

(b) Unless the Personal Property is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, Beneficiary shall give Trustor at least five (5) days' prior written notice of the time and place of any public sale of the Personal Property or other intended disposition thereof to be made. Such notice may be mailed to Trustor at the address set forth in Section 5.05.

(c) The proceeds of any sale under Section 3.04(a)(iv) shall be applied, unless otherwise directed by statute, as provided in Clause 7 of the Agency and Disbursement Agreement. Beneficiary shall have the right to enforce one or more remedies hereunder, successively or concurrently, and such action shall not operate to estop or prevent Beneficiary from pursuing any further remedy that it may have. Any repossession or retaking or sale of the Personal Property pursuant to the terms hereof shall not operate to release Trustor until full payment of any deficiency has been made in cash.

3.05 Security Agreement. This Deed of Trust constitutes and shall be deemed to be a "security agreement" for all purposes of the Uniform Commercial Code of Arizona and Beneficiary shall be entitled to all the rights and remedies of a "secured party" under such Uniform Commercial Code of Arizona.

3.06 Fixture Filing. Upon its recording in the real property records, this Deed of Trust shall be effective as a financing statement filed as a fixture filing. In addition, a carbon, photographic or other reproduced copy of this Deed of Trust and/or any financing statement relating hereto shall be sufficient for filing and/or recording as a financing statement. The filing of any other financing statement relating to any personal property, rights or interests described herein shall not be construed to diminish any right or priority hereunder.

## ARTICLE IV
## REMEDIES UPON DEFAULT

4.01 Events of Default. An Event of Default under the Loan Agreement shall be an Event of Default hereunder.

4.02 Acceleration Upon Default; Additional Remedies. Upon the occurrence of an Event of Default, Beneficiary may declare all or any part of the Obligations immediately due and payable without any presentment, demand, protest or notice of any kind. Beneficiary may, in addition to the exercise of any or all of the remedies specified in Section 3.04:

(a) Either in person or by agent, with or without bringing any action or proceeding, or by a receiver appointed by a court and without regard to the adequacy of its security, enter upon and take possession of the Trust Estate, or any part thereof, in its own name or in the name of Trustee, and do any acts that it deems necessary or desirable to preserve the value, marketability or rentability of the Trust Estate, or any part thereof or interest therein, increase the income therefrom or protect the security hereof and, with or without taking possession of the Trust Estate, sue for or otherwise collect the Rents, or any part thereof, including, without limitation, those past due and unpaid, and apply the same, less costs and expenses of operation and collection (including, without limitation, attorneys' fees) upon the Obligations, all in such order as Beneficiary may determine. The entering upon and taking possession of the Trust Estate, the collection of such Rents and the application thereof as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done in response to such default or pursuant to such notice of default and, notwithstanding the continuance in possession of all or any portion of the Trust Estate or the collection, receipt and application of Rents, Trustee or Beneficiary shall be entitled to exercise every right provided for in any of the Financing Documents or by law upon occurrence of any Event of Default, including, without limitation, the right to exercise the power of sale;

(b) Commence an action to foreclose the lien of this Deed of Trust as a mortgage, appoint a receiver, or specifically enforce any of the covenants hereof;

(c) Exercise of the power of sale herein contained and deliver to Trustee a written statement of breach, notice of default and election to cause Trustor's interest in the Trust Estate to be sold; or

(d) Exercise all other rights and remedies provided herein, in any Financing Document or other document or agreement now or hereafter securing or guarantying all or any portion of the Obligations, or by law, including, without limitation, the rights and remedies provided in A.R.S. Section 33-702.B.

4.03 Exercise of Power of Sale. If Beneficiary elects to exercise the power of sale herein contained, Beneficiary shall notify Trustee and shall deposit with Trustee this Deed of Trust and the Notes and such receipts and evidence of expenditures made and secured hereby as Trustee may require.

(a) Upon receipt of such statement and notice from Beneficiary, Trustee shall cause to be recorded, published and delivered to Trustor such Notice of Sale as then required by law. Trustee shall, without demand on Trustor, after lapse of such time as may then be required by law and after recordation of such Notice of Sale and Notice of Sale having been given as required by law, sell the Trust Estate at the time and place of sale fixed by it in said Notice of Sale, either as a whole, or in separate lots or parcels or items as Trustee shall deem expedient, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money of the United States payable at the time of sale. Trustee shall deliver to such purchaser or purchasers thereof its good and sufficient deed or deeds conveying the property so sold, but without any covenant or warranty, express or implied. The recitals in such deed of any matters or facts shall be

conclusive proof of the truthfulness thereof. Any person, including, without limitation, Trustor, Trustee or Beneficiary, may purchase at such sale and Trustor hereby covenants to warrant and defend the title of such purchaser or purchasers.

(b) After deducting all costs, fees and expenses of Trustee and of this Trust, including, without limitation, Trustee's fees and reasonable attorneys' fees, and costs of evidence of title in connection with sale, Trustee shall apply the proceeds of sale, unless otherwise directed by statute, in accordance with Clause 7 of the Agency and Disbursement Agreement.

(c) Subject to A.R.S. Section 33-810.B, Trustee may postpone sale of all or any portion of the Trust Estate by public announcement at such time and place of sale, and from time to time thereafter may postpone such sale by public announcement or subsequently noticed sale, and without further notice make such sale at the time fixed by the last postponement, or may, in it discretion, give a new notice of sale.

4.04 Personal Property. It is the express understanding and intent of the parties that as to any personal property interests subject to Chapter 9 of the Uniform Commercial Code of Arizona, Beneficiary, upon an Event of Default, may proceed under such Uniform Commercial Code of Arizona or may proceed as to both real and personal property interests in accordance with the provisions of this Deed of Trust and its rights and remedies in respect to real property, as specifically permitted under A.R.S. Section 47-9604.A, and treat both real and personal property interests as one parcel or package of security.

4.05 Appointment of Receiver. Upon the occurrence of an Event of Default, Beneficiary, as a matter of right and without notice to Trustor or any one claiming under Trustor, and without regard to the then value of the Trust Estate or the interest of Trustor therein, shall have the right to apply to any court having jurisdiction to appoint a receiver or receivers of the Trust Estate, and Trustor hereby irrevocably consents to such appointment and waives notice of any application therefor. Any such receiver or receivers shall have all the usual powers and duties of receivers in like or similar cases and all the powers and duties of Beneficiary in case of entry as provided herein and shall continue as such and exercise all such powers until the later of the date of confirmation of sale of the Trust Estate or the date of expiration of any redemption period unless such receivership is sooner terminated.

4.06 Remedies Not Exclusive. Trustee and Beneficiary, and each of them, shall be entitled to enforce payment and performance of any and all of the Obligations and to exercise all rights and powers under the Financing Documents and under the law now or hereafter in effect, notwithstanding some or all of the Obligations may now or hereafter be otherwise secured or guaranteed. Neither the acceptance of this Deed of Trust nor its enforcement, whether by court action or pursuant to the power of sale or other rights herein contained, shall prejudice or in any manner affect Trustee's or Beneficiary's right to realize upon or enforce any other security or guaranty now or hereafter held by Trustee or Beneficiary, it being agreed that Trustee and Beneficiary, and each of them shall be entitled to enforce this Deed of Trust and any other security or any guaranty now or hereafter held by Beneficiary or Trustee in such order and manner as they or either of them may in their absolute discretion determine. No remedy herein conferred upon or reserved to Trustee or Beneficiary is intended to be exclusive of any other

remedy herein or by law provided or permitted, but each shall be cumulative and shall be in addition to every other remedy given hereunder or now or hereafter existing under the law. Every power or remedy given by any of the Financing Documents or by law to Trustee or Beneficiary or to which either of them may be otherwise entitled, may be exercised, concurrently or independently, from time to time and as often as may be deemed expedient by Trustee or Beneficiary and, to the extent permitted by law, either of them may pursue inconsistent remedies.

4.07 Request for Notice. Trustor hereby requests a copy of any notice of default and that any notice of sale hereunder be mailed to it at the address set forth in Section 5.05.

## ARTICLE V
## MISCELLANEOUS

5.01 Change, Discharge, Termination, or Waiver. No provision of this Deed of Trust may be changed, discharged, terminated, or waived except in a writing signed by the party against whom enforcement of the change, discharge, termination, or waiver is sought. No failure on the part of Beneficiary to exercise and no delay by Beneficiary in exercising any right or remedy under the Financing Documents or under the law shall operate as a waiver thereof.

5.02 Trustor Waiver of Rights. Trustor waives, to the extent permitted by law, (a) the benefit of all laws now existing or that may hereafter be enacted providing for any appraisement before sale of any portion of the Trust Estate, and (b) all rights of redemption, valuation, appraisement, stay of execution, notice of election to mature or declare due the Obligations and marshaling in the event of foreclosure of the liens hereby created, and (c) all rights and remedies that Trustor may have or be able to assert by reason of the laws of the State of Arizona pertaining to the rights and remedies of sureties including, without limitation, A.R.S. Sections 12-1641 through 12-1646, and Arizona Rules of Civil Procedure 17(f).

5.03 Statements by Trustor. Trustor shall, within ten (10) days after written notice thereof from Beneficiary, deliver to Beneficiary a written statement stating the unpaid principal of and interest on the Notes and any other amounts secured by this Deed of Trust and stating whether any offset or defense exists against such principal and interest or such other amounts.

5.04 Reconveyance by Trustee. Upon written request of Beneficiary stating that all Obligations have been satisfied in full, and upon surrender of this Deed of Trust and the Notes to Trustee for cancellation and retention and upon payment by Trustor of Trustee's fees, Trustee shall reconvey to Trustor, or to the person or persons legally entitled thereto, without warranty, any portion of the Trust Estate then held hereunder. The recitals in such reconveyance of any matters or facts shall be conclusive proof of the truthfulness thereof. The grantee in any reconveyance may be described as "the person or persons legally entitled thereto."

5.05 Notices. All notices, requests and demands to be made hereunder to the parties hereto shall be in writing and shall be delivered by hand or sent by registered or certified mail, return receipt requested, through the United States Postal Service to the addresses shown below or such other address which the parties may provide to one another in accordance herewith. Such notices, requests and demands, if sent by mail, shall be deemed given two (2) days after

deposit in the United States mail, and if delivered by hand, shall be deemed given when delivered.

To Beneficiary: Pinnacle West Energy Corporation
400 North 5th Street
Phoenix, Arizona 85004
Attention: Warren Kotzmann, V. P., Finance and Corporate Services
Mail Station 9988

To Trustor: Arizona Public Service Company
400 North 5th Street
Phoenix, Arizona 85004
Attention: Don Robinson, V.P., Finance and Planning
Mail Station 9909

5.06 Acceptance by Trustee. Trustee accepts this Trust when this Deed of Trust, duly executed and acknowledged, is made a public record as provided by law.

5.07 Captions and References. The headings at the beginning of each section of this Deed of Trust are solely for convenience and are not part of this Deed of Trust. Unless otherwise indicated, each reference in this Deed of Trust to a section or an exhibit is a reference to the respective section herein or exhibit hereto.

5.08 Invalidity of Certain Provisions. If any provision of this Deed of Trust is unenforceable, the enforceability of the other provisions shall not be affected and they shall remain in full force and effect. If the lien of this Deed of Trust is invalid or unenforceable as to any part of the debt, or if the lien is invalid or unenforceable as to any part of the Trust Estate, the unsecured or partially secured portion of the debt shall be completely paid prior to the payment of the remaining and secured or partially secured portion of the debt, and all payments made on the debt, whether voluntary or under foreclosure or other enforcement action or procedure, shall be considered to have been first paid on and applied to the full payment of that portion of the debt which is not secured or fully secured by the lien of this Deed of Trust.

5.09 Subrogation. To the extent that proceeds of the Notes are used to pay any outstanding lien, charge or prior encumbrance against the Trust Estate, such proceeds have been or will be advanced by Beneficiary at Trustor's request and Beneficiary shall be subrogated to any and all rights and liens held by any owner or holder of such outstanding liens, charges and prior encumbrances, irrespective of whether said liens, charges or encumbrances are released.

5.10 Attorneys' Fees. If any or all of the Obligations are not paid when due or if an Event of Default occurs, Trustor agrees to pay all costs of enforcement and collection and preparation therefore (including, without limitation, reasonable attorney's fees) whether or not any action or proceeding is brought (including, without limitation, all such costs incurred in connection with any bankruptcy, receivership, or other court proceedings (whether at the trial or appellate level)), together with interest therein from the date of demand at the Default Rate.

5.11 Governing Law. THIS DEED OF TRUST SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF ARIZONA.

5.12 Joint and Several Obligations. If this Deed of Trust is signed by more than one party as Trustor, all obligations of Trustor herein shall be the joint and several obligations of each party executing this Deed of Trust as Trustor.

5.13 Number and Gender. In this Deed of Trust the singular shall include the plural and the masculine shall include the feminine and neuter gender and vice versa, if the context so requires.

5.14 No Merger of Lease. If both the lessor's and lessee's estate under any lease or any portion thereof which constitutes a part of the Trust Estate shall at any time become vested in one owner, this Deed of Trust and the lien created hereby shall not be destroyed or terminated by application of the doctrine of merger unless Beneficiary so elects as evidenced by recording a written declaration executed by Beneficiary so stating, and, unless and until Beneficiary so elects, Beneficiary shall continue to have and enjoy all of the rights and privileges of Beneficiary as to the separate estates. In addition, upon the foreclosure of the lien created by this Deed of Trust on the Trust Estate pursuant to the provisions hereof, any leases or subleases then existing and affecting all or any portion of the Trust Estate shall not be destroyed or terminated by application of the law of merger or as a matter of law or as a result of such foreclosure unless Beneficiary or any purchaser at such foreclosure sale shall so elect. No act by or on behalf of Beneficiary or any such purchaser shall constitute a termination of any lease or sublease unless Beneficiary or such purchaser shall give written notice thereof to such tenant or subtenant.

5.15 Status of Title. Trustor represents and warrants that it is the lawful owner of the Trust Estate free and clear of all Liens and Encumbrances and holds a fee simple estate in the Premises and Improvements, subject only to the Permitted Exceptions and that Trustor has full right, power and authority to convey and mortgage the same and to execute this Deed of Trust.

5.16 Integration. The Financing Documents contain the complete understanding and agreement of Trustor and Beneficiary and supersede all prior representations, warranties, agreements, arrangements, understandings, and negotiations.

5.17 Binding Effect. The Financing Documents will be binding upon, and inure to the benefit of, Trustor, Trustee and Beneficiary and their respective successors and assigns. Trustor may not delegate its obligations under the Financing Documents.

5.18 Time of the Essence. Time is of the essence with regard to the each provision of the Financing Documents as to which time is a factor.

5.19 Survival. The representations, warranties, and covenants of the Trustor and the Financing Documents shall survive the execution and delivery of the Financing Documents.

IN WITNESS WHEREOF, Trustor has executed this Deed of Trust as of the day and year first above written.

PINNACLE WEST ENERGY CORPORATION, an Arizona corporation

By: _____

Name: Warren Kotzmann

Title: Vice President, Finance and Corporate Services

"Trustor"

STATE OF ARIZONA )
) ss.
County of Maricopa )

The foregoing instrument was acknowledged before me this 5th day of December, 2002, by Warren Kotzmann, the Vice President, Finance and Corporate Services of PINNACLE WEST ENERGY CORPORATION, An Arizona corporation, on behalf of the corporation.

Norann Asciutto
Notary Public

My commission expires:
2/12/06

OFFICIAL SEAL
NORANN ASCIUTTO
Notary Public - State of Arizona
MARICOPA COUNTY
My comm. expires Feb. 12, 2006

# EXHIBIT A

A parcel of land located within the Saguaro Steam Electric Station as described in Arizona State Land Patent 4763, Docket 112, Page 128. Said parcel being more particularly described as being located in the Northeast quarter of Section 15, Township 10 South, Range 10 East, Gila and Salt River Base and Meridian, Pinal County, Arizona.

**COMMENCING** at the Northeast corner of Section 15, Township 10 South, Range 10 East; Thence, South 00° 00' 00" East (basis of bearing assumed) along the East line of said section, a distance of 1,915.64 feet to the **TRUE POINT OF BEGINNING** of the parcel herein described;

Thence, South 00° 00' 00" East (assumed) along the East line of said parcel, a distance of 300.00 feet;

Thence, North 90° 00' 00" West along the South line of the parcel herein described, a distance of 1,000.00 feet;

Thence, North 00° 00' 00" East along the West line of said parcel, a distance of 300.00 feet;

Thence North 90° 00' 00" East along the North line of the parcel herein described, a distance of 1,000.00 feet to the **TRUE POINT OF BEGINNING** of the parcel herein described, said parcel containing 6.8871 acres more or less.

## EXHIBIT B

## DESCRIPTION OF PERSONAL PROPERTY

(a) All personal property, (including, without limitation, all goods, supplies, equipment, furniture, furnishings, fixtures, machinery, and inventory) in which Trustor now or hereafter acquires an interest or right, which is now or hereafter located on or affixed to the Premises or the Improvements, together with all books, records, leases and other agreements, documents, and instruments of whatever kind or character, relating to the Premises, Improvements, or such personal property;

(b) All fees, income, rents, issues, profits, earnings, receipts, royalties, and revenues which, after the date hereof and while any portion of the Obligations remains unpaid or unperformed, may accrue from the personal property referenced in Paragraph (a) above, or any part thereof or from the Premises, the Improvements or any other part of the Trust Estate, or which may be received or receivable by Trustor from any hiring, using, letting, leasing, subhiring, subletting, subleasing, occupancy, operation, or use thereof;

(c) All of Trustor's present and future rights to receive payments of money, services, or property, relating to the Premises, the Improvements, or the personal property described in Paragraph (a) above including, without limitation, rights to all deposits from tenants of the Premises or Improvements, accounts and other accounts receivable, deposit accounts, chattel paper, notes, drafts, contract rights, instruments, general intangibles, and principal, interest and payments due on account of goods sold or leased, services rendered, loans made or credit extended, together with title to or interest in all agreements, documents, and instruments, evidencing, securing or guarantying the same;

(d) All other intangible property and rights relating to the Premises, the Improvements, the personal property described in Paragraph (a) above or the operation, occupancy, or use thereof, including, without limitation, all governmental and non-governmental permits, licenses, and approvals relating to construction on or operation, occupancy, or use of the Premises or Improvements, all names under or by which the Premises or Improvements may at any time be operated or known, all rights to carry on business under any such names, or any variant thereof, all trade names and trademarks relating in any way to the Premises or the Improvements, and all good will in any way relating to the Premises or the Improvements;

(e) Trustor's rights under all insurance policies covering the Premises, the Improvements, the Personal Property, and the other parts of the Trust Estate and any and all proceeds, loss payments, and premium refunds payable regarding the same;

(f) All water stock relating to the Premises;

(g) All causes of action, claims, compensation, and recoveries for any damage to, destruction of, or condemnation or taking of the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate, or for any conveyance in lieu thereof, whether direct or consequential, or for any damage or injury to the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate, or for any loss or diminution in value of the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate;

(h) All architectural, structural, mechanical, and engineering plans and specifications prepared for construction of Improvements or extraction of minerals or gravel from the Premises and all studies, data, and drawings related thereto; and also all contracts and agreements of the Trustor relating to the aforesaid plans and specifications or to the aforesaid studies, data, and drawings or to the construction of Improvements on or extraction of minerals or gravel from the Premises;

(i) All proceeds from sale or disposition of any of the aforesaid collateral; and

(j) All Trustor's rights in proceeds of the loan evidenced by the Note.

(k) As used in this Exhibit B the terms "Premises", "Improvements", and "Personal Property" shall have the meanings set forth in the Deed of Trust to which this Exhibit B is attached.

# EXHIBIT C

"Permitted Exceptions" means the following:

1. Sale, transfer, or other disposition of any Personal Property that is consumed or worn out in ordinary usage and that is promptly replaced with similar items of equal or greater value.

2. Any purchase, sale, transportation, exchange, option, or similar transaction in the ordinary course of Trustor's business with respect to fuel, electricity and/or capacity, including, but not limited to, system, plant or unit contingent transactions or system, plant or unit specific tolling agreements (collectively, the "Transactions"), and the assignment of such Transactions to or from the Trustor.

3. Liens and Encumbrances being contested in accordance with Section 1.17 of the Deed of Trust.

4. Impositions being contested in accordance with Section 1.07(d) of this Deed of Trust.

5. Items recorded in the Official records of the county prior to the date of recording of this Deed of Trust.

When Recorded Return To:

Snell & Wilmer, LLP
One Arizona Center
Phoenix, Arizona 85004
Attn: David J. Carroll

Recorder's Use
(West Phoenix-Units 4 and 5)

**DEED OF TRUST AND FIXTURE FILING**
**(With Assignment of Rents and Security Agreement)**
**(VARIABLE RATE)**

**THIS DEED OF TRUST SECURES VARIABLE RATE PROMISSORY NOTES.**

THIS DEED OF TRUST AND FIXTURE FILING (With Assignment of Rents and Security Agreement) (as it may be amended and modified from time to time, the "Deed of Trust") is made as of December 4, 2002, by and among **PINNACLE WEST ENERGY CORPORATION, an Arizona corporation ("Trustor")**, whose mailing address is 400 North 5th Street, Phoenix, Arizona 85004, **FIRST AMERICAN TITLE INSURANCE COMPANY, a California corporation ("Trustee")**, whose mailing address is P.O. Box 2922, Phoenix, Arizona, and **ARIZONA PUBLIC SERVICE COMPANY, an Arizona corporation, ("Beneficiary")**, whose mailing address is 400 North 5th Street, Phoenix, Arizona 85004. Capitalized terms used in this Deed of Trust not otherwise defined herein shall be as used in that certain 364-Day Credit Agreement, dated of even date herewith, by and between Beneficiary, as Lender and PINNACLE WEST CAPITAL CORPORATION, an Arizona corporation, as "Borrower" (the "Loan Agreement").

FOR GOOD AND VALUABLE CONSIDERATION, including the indebtedness herein recited and the trust herein created, the receipt of which is hereby acknowledged, Trustor hereby irrevocably grants, transfers, conveys and assigns to Trustee, IN TRUST, WITH POWER OF SALE, for the benefit and security of Beneficiary, under and subject to the terms and conditions hereinafter set forth, that certain real property located in the County of Maricopa, State of Arizona, more particularly described in Exhibit A attached hereto and incorporated herein by this reference (the "Premises");

TOGETHER WITH any and all buildings and other improvements now or hereafter erected on the Premises including, without limitation, fixtures, attachments, appliances, equipment, machinery, and other personal property attached to such buildings and other improvements (the "Improvements"), all of which shall be deemed and construed to be a part of the real property;

TOGETHER WITH all rents, issues, profits, damages, royalties, income and other benefits now or hereafter derived from the Premises and the Improvements (collectively the "Rents"), subject to the terms and provisions of Article II of this Deed of Trust with respect to all leases and subleases of the Premises or Improvements now or hereafter existing or entered into,

or portions thereof, granted by Trustor, and further subject to the right, power and authority hereinafter given to Trustor to collect and apply such Rents;

TOGETHER WITH all interests, estates or other claims, both in law and in equity, which Trustor now has or may hereafter acquire in the Premises or the Improvements;

TOGETHER WITH all easements, rights-of-way and other rights now owned or hereafter acquired by Trustor used in connection with the Premises or the Improvements or as a means of access thereto (including, without limitation, all rights pursuant to any trackage agreement and all rights to the nonexclusive use of common drive entries, and all tenements, hereditaments and appurtenances thereof and thereto) and all water and water rights and shares of stock evidencing the same;

TOGETHER WITH all leasehold estate, right, title and interest of Trustor in and to all leases or subleases covering the Premises or the Improvements or any portion thereof now or hereafter existing or entered into, and all right, title and interest of Trustor thereunder including, without limitation, all rights of Trustor against guarantors thereof, all cash or security deposits, advance rentals, and deposits or payments of similar nature (collectively, the "Leases");

TOGETHER WITH all right, title and interest now owned or hereafter acquired by Trustor in and to any greater estate in the Premises or the Improvements;

TOGETHER WITH all right, title, and interest of Trustor in (i) the property and interests in property described on Exhibit B attached hereto and incorporated herein by reference, and (ii) all proceeds thereof (such personal property and proceeds are referred to herein collectively as the "Personal Property");

TOGETHER WITH all right, title and interest of Trustor, now owned or hereafter acquired, in and to any land lying within the right-of-way of any street, open or proposed, adjoining the Premises, and any and all sidewalks, alleys and strips and gores of land adjacent to or used in connection with the Premises;

TOGETHER WITH all the estate, interest, right, title, other claim or demand, both in law and in equity (including, without limitation, claims or demands with respect to the proceeds of insurance in effect with respect thereto) that Trustor now has or may hereafter acquire in the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate (as defined below), and any and all awards made for the taking by eminent domain, or by any proceeding of purchase in lieu thereof, of the whole or any part of the Trust Estate (including, without limitation, any awards resulting from a change of grade of streets and awards for severance damages);

TOGETHER WITH all proceeds of the foregoing.

The entire estate, property, right, title and interest hereby conveyed to Trustee may hereafter be collectively referred to as the "Trust Estate."

FOR THE PURPOSE OF SECURING (in such order of priority as Beneficiary may elect) the following (the "Obligations"):

(a) all obligations of Borrower to Beneficiary pursuant to the Loan Agreement in the maximum principal amount of **ONE HUNDRED TWENTY-FIVE MILLION AND NO/100 DOLLARS ($125,000,000.00)**, as more particularly evidenced by the Notes (the Loan Agreement contains a provision providing for a variable rate of interest under the Notes); and

(b) payment of all sums advanced by Beneficiary to protect the Trust Estate, with interest thereon equal to the Base Rate plus three percent (3%);

(c) performance of every obligation of Borrower and/or Trustor contained in the Financing Documents (as defined below);

(d) performance of every obligation of Trustor contained in any agreement, document, or instrument now or hereafter executed by Trustor reciting that the obligations thereunder are secured by this Deed of Trust; and

(e) for the benefit of Beneficiary, compliance with and performance of each and every provision of any declaration of covenants, conditions and restrictions, any maintenance, easement and party wall agreement, or any other agreement, document, or instrument by which the Trust Estate is bound or may be affected.

This Deed of Trust, the Notes, the Loan Agreement, and any other deeds of trust, mortgages, agreements, guaranties or other instruments given to evidence or further secure the payment and performance of any or all of the Obligations, as the foregoing may be amended, modified, extended, or renewed from time to time may hereinafter be collectively referred to as the "Financing Documents."

TRUSTOR HEREBY COVENANTS AND AGREES AS FOLLOWS:

## ARTICLE I
## COVENANTS AND AGREEMENTS OF TRUSTOR

1.01 Maintenance, Repair, Alterations. Trustor shall keep the Trust Estate in good condition and repair. Trustor shall not remove, demolish, or substantially alter any of the Improvements, except with the prior written consent of Beneficiary; provided, however, that the written consent of Beneficiary shall not be required for any removal, demolition or alterations to the Improvements resulting from Trustor's ongoing construction program or in connection with Trustor's Prudent Utility Practices. For purposes of this Deed of Trust, "Prudent Utility Practices" shall mean those nationally recognized practices, methods, standards and acts (including, but not limited to, the practices, methods, standards and acts engaged in or approved by a significant portion of the power generation industry in United States), that, in the exercise of reasonable prudent judgment in light of the facts known or that should reasonably have been known at the time a decision was made, would have been expected to accomplish the desired result consistent with good engineering practices, safety, reliability, and good business practices, and which practices, methods, standards and acts conform to a majority of the operation and maintenance standards followed by power generating plants of similar type, size and capacity as the Premises. Prudent Utility Practices are not limited to the optimum practice or method to the

exclusion of others, but rather refer to the reasonable practices and methods used by a significant portion of the power generation industry in the United States. Trustor shall complete promptly and in a good and workmanlike manner any Improvement that may be now or hereafter constructed on the Premises and promptly restore in like manner any Improvements that may be damaged or destroyed from any cause whatsoever and pay when due all claims for labor performed and materials furnished therefor. Trustor shall comply with all Requirements (as defined below) and shall not suffer to occur or exist any violation of any Requirement. Trustor shall not commit or permit any waste or deterioration of the Trust Estate, and, to the extent allowed by law, shall keep and maintain abutting grounds, sidewalks, roads, parking and landscape areas in good and neat order and repair. Trustor shall perform its obligations under each Lease. "Requirement" and "Requirements" mean, respectively, each and all obligations and requirements now or hereafter in effect by which Trustor or the Trust Estate are bound or which are otherwise applicable to the Trust Estate, construction of any Improvements on the Trust Estate, or operation, occupancy or use of the Trust Estate (including, without limitation (i) such obligations and requirements imposed by common law or any law, statute, ordinance, regulation, or rule (federal, state, or local), and (ii) such obligations and requirements of, in, or in respect of (A) any consent, authorization, license, permit, or approval relating to the Trust Estate, (B) any condition, covenant, restriction, easement, or right-of-way reservation applicable to the Trust Estate, (C) any Lien or Encumbrance, (D) any other agreement, document, or instrument to which Trustor is a party or by which Trustor or the Trust Estate is bound or affected, and (E) any order, writ, judgment, injunction, decree, determination, or award of any arbitrator, other private adjudicator, court, government, or governmental authority (federal, state, or local) to which Trustor is a party or by which Trustor or the Trust Estate is bound or affected).

1.02 Required Insurance. Trustor shall at all times provide, maintain and keep in force or cause to be provided, maintained and kept in force with respect to the Trust Estate, at no expense to Trustee or Beneficiary, policies of insurance in forms and amounts and issued by companies reasonably satisfactory to Beneficiary covering such casualties, risks, perils, liabilities and other hazards as is required under the Loan Agreement. All such policies of insurance required by the terms of this Deed of Trust or the Loan Agreement shall contain an endorsement or agreement by the insurer that any loss shall be payable in accordance with the terms of such policy notwithstanding any act or negligence of Trustor or any party holding under Trustor that might otherwise result in forfeiture of said insurance and the further agreement of the insurer waiving all rights of setoff, counterclaim or deductions against Trustor.

1.03 Delivery of Policies, Payment of Premiums.

(a) At Beneficiary's option all policies of insurance shall either have attached thereto a lender's loss payable endorsement for the benefit of Beneficiary in form satisfactory to Beneficiary or shall name Beneficiary as an additional insured. Trustor shall furnish Beneficiary with certificates of insurance for each required policy setting forth the coverage, the limits of liability, the name of the carrier, the policy number and the period of coverage. If Beneficiary consents, Trustor may provide any of the required insurance through blanket policies carried by Trustor and covering more than one location, or by policies procured by a tenant or other party holding under Trustor; provided, however, all such policies shall meet the requirements referred to in Section 1.02. At least thirty (30) days prior to the expiration of each required policy, Trustor

shall deliver to Beneficiary evidence reasonably satisfactory to Beneficiary of the payment of premium and the renewal or replacement of such policy continuing insurance in form as required by this Deed of Trust. All such policies shall contain a provision that, notwithstanding any contrary agreement between Trustor and insurance company, such policies will not be cancelled, allowed to lapse without renewal, surrendered or materially amended, which term shall include any reduction in the scope or limits of coverage, without at least thirty (30) days' prior written notice to Beneficiary.

(b) In the event Trustor fails to obtain, maintain, or deliver to Beneficiary the policies of insurance with respect to the Trust Estate required by this Deed of Trust, Beneficiary may, at Beneficiary's election, but without any obligation so to do, procure such insurance or single-interest insurance for such risks covering Beneficiary's interest, and Trustor will pay all premiums thereon promptly upon demand by Beneficiary, and until such payment is made by Trustor, the amount of all such premiums shall bear interest at the Default Rate. Upon the occurrence and during the continuation of an Event of Default and request by Beneficiary, Trustor shall deposit with Beneficiary in monthly installments, an amount equal to one-twelfth (1/12) of the estimated aggregate annual insurance premiums on all policies of insurance required by this Deed of Trust (funds deposited for this purpose are referred to as "Insurance Impounds"). In such event Trustor further agrees to cause all bills, statements, or other documents relating to the foregoing insurance premiums to be sent or mailed directly to Beneficiary. Upon receipt of such bills, statements, or other documents evidencing that a premium for a required policy is then payable, and provided there are sufficient Insurance Impounds, Beneficiary shall timely pay such amounts as may be due thereunder out of the Insurance Impounds. If at any time and for any reason the Insurance Impounds are or will be insufficient to pay such amounts as may be then or subsequently due, Beneficiary shall notify Trustor and Trustor shall immediately deposit an amount equal to such deficiency with Beneficiary. Notwithstanding the foregoing, nothing contained herein shall cause Beneficiary to be deemed a trustee of Insurance Impounds or to be obligated to pay any amounts in excess of the amount of the Insurance Impounds, nor shall anything contained herein modify the obligation of Trustor set forth in Section 1.01 to obtain and maintain insurance. Beneficiary may commingle Insurance Impounds with its own funds, and Trustor shall not be entitled to interest thereon. Beneficiary may reserve for future payments of premiums such portion of Insurance Impounds as Beneficiary in its absolute and sole discretion deems proper. If Trustor fails to deposit with Beneficiary sums sufficient to pay fully such premiums at least thirty (30) days before delinquency thereof, Beneficiary may, at Beneficiary's election, but without any obligation so to do, advance any amounts required to make up the deficiency, which advances, if any, shall be secured hereby and shall be repayable to Beneficiary upon demand with interest from the date advanced at the Default Rate, or at the option of Beneficiary the latter may, without making any advance whatever, apply any Insurance Impounds to payment of the Obligations in such order as Beneficiary may determine, notwithstanding that such Obligations may not yet be due. Upon the occurrence of an Event of Default, Beneficiary may, at any time, at Beneficiary's option, apply any Insurance Impounds or Impositions Impounds under this Section 1.03 or Section 1.07, any funds paid as Rents, and any other funds of Trustor held by Beneficiary to payment of any of the Obligations, in such manner and order as Beneficiary may elect, notwithstanding that such Obligations may not yet be due.

1.04 Casualties; Insurance Proceeds.

(a) Trustor shall give prompt written notice thereof to Beneficiary after the happening of any casualty to or in connection with the Trust Estate or any part thereof, whether or not covered by insurance. All proceeds of insurance shall be payable to Beneficiary, and Trustor hereby authorizes and directs any affected insurance company to make payment of such proceeds directly to Beneficiary. If Trustor receives any proceeds of insurance resulting from such casualty, Trustor shall promptly pay over such proceeds to Beneficiary. All proceeds of insurance will be applied by Beneficiary to payment of the Obligations in such order as Beneficiary shall determine.

(b) Trustor shall not be excused from repairing or maintaining the Trust Estate as provided in Section 1.01 hereof or restoring all damage or destruction to the Trust Estate, regardless of whether or not there are insurance proceeds available to Trustor or whether any such proceeds are sufficient in amount, and the application or release by Beneficiary of any insurance proceeds shall not cure or waive any default or notice of default under this Deed of Trust or invalidate any act done pursuant to such default or notice of default.

1.05 Assignment of Policies Upon Foreclosure. In the event of foreclosure of this Deed of Trust as a mortgage, a sale under the power of sale, or any other transfer of title or assignment of the Trust Estate in extinguishment, in whole or in part, of the Obligations, all right, title and interest of Trustor in and to all policies of insurance required by Section 1.02 shall inure to the benefit of and pass to the successor in interest to Trustor or the purchaser or grantee of the Trust Estate, to the extent such policies are assignable pursuant to the terms thereof.

1.06 Indemnification; Subrogation; Waiver of Offset.

(a) If Beneficiary is made a party to any litigation concerning the Notes, this Deed of Trust, any of the Financing Documents, the Trust Estate or any part thereof or interest therein, or the occupancy of the Trust Estate by Trustor, which litigation is not the result of a claim or counterclaim made by Trustor or Borrower against Beneficiary for breach of Beneficiary's obligations under the Financing Documents (each, an "Excluded Claim"), then Trustor shall indemnify, defend and hold Beneficiary harmless for, from and against all liability by reason of said litigation, including reasonable attorneys' fees and expenses incurred by Beneficiary as a result of any such litigation, whether or not any such litigation is prosecuted to judgment. Beneficiary may employ an attorney or attorneys to protect its rights hereunder, and in the event of such employment following any breach by Trustor, Trustor shall pay Beneficiary reasonable attorneys' fees and expenses incurred by Beneficiary, whether or not an action is actually commenced against Trustor by reason of its breach.

(b) Trustor waives any and all right to claim or recover against Beneficiary, its successors and assigns, their directors, officers, employees, agents and representatives, for loss of or damage to Trustor, the Trust Estate, Trustor's property or the property of others under Trustor's control from any cause insured against or required to be insured against by this Deed of Trust.

(c) All sums payable by Trustor pursuant to this Deed of Trust shall be paid without notice (except for such notice as may be expressly required hereunder or under the other Financing Documents), demand, counterclaim, setoff, deduction or defense and without abatement, suspension, deferment, diminution or reduction, and the obligations and liabilities of Trustor hereunder shall in no way be released, discharged or otherwise affected (except as expressly provided herein) by reason of: (i) any damage to or destruction of or any condemnation or similar taking of the Trust Estate or any part thereof; (ii) any restriction or prevention of or interference by any Person (as defined below) with any use of the Trust Estate or any part thereof; (iii) any title defect or encumbrance or any eviction from the Premises or the Improvements or any part thereof by title paramount or otherwise; or (iv) any bankruptcy, insolvency, reorganization, composition, adjustment, dissolution, liquidation or other like proceeding relating to Beneficiary, or any action taken with respect to this Deed of Trust by any trustee or receiver of Beneficiary, or by any court, in any such proceeding. Except as expressly provided herein, Trustor waives all rights now or hereafter conferred by statute or otherwise to any abatement, suspension, deferment, diminution or reduction of any sum secured hereby and payable by Trustor. "Person" means any natural person, any unincorporated association, any corporation, any partnership, any joint venture, any trust, any other legal entity, or any governmental authority (federal, state, local or foreign), excluding Beneficiary.

1.07 Impositions.

(a) Trustor shall pay, or cause to be paid, prior to delinquency, all real property taxes and assessments, general and special, and all other taxes and assessments of any kind or nature whatsoever, (including, without limitation, nongovernmental levies or assessments such as maintenance charges, levies, or charges resulting from covenants, conditions and restrictions affecting the Trust Estate) that are assessed or imposed upon the Trust Estate or become due and payable and that create, may create, or appear to create a lien upon the Trust Estate (the above are sometimes referred to herein individually as an "Imposition" and collectively as "Impositions"), provided, however, that if by law any Imposition is payable, or may at the option of the taxpayer be paid, in installments, Trustor may pay the same or cause it to be paid, together with any accrued interest on the unpaid balance of such Imposition, in installments as the same becomes due and before any fine, penalty, interest, or cost may be added thereto for the nonpayment of any such installment and interest.

(b) If at any time after the date hereof there shall be assessed or imposed a fee, tax, or assessment on Beneficiary and measured by or based in whole or in part upon this Deed of Trust or the outstanding amount of the Obligations, then all such taxes, assessments or fees shall be deemed to be included within the term "Impositions" as defined in Section 1.07(a) and Trustor shall pay and discharge the same as herein provided with respect to the payment of Impositions. If Trustor fails to pay such Impositions prior to delinquency, Beneficiary may declare all or part of the Obligations, immediately due and payable. If Trustor is prohibited by law from paying such Impositions, Beneficiary may declare all or part of the Obligations due and payable on a

date which is not less than six (6) months from the date such prohibition is imposed on Trustor.

(c) Subject to the provisions of Section 1.07(d) and upon request by Beneficiary, Trustor shall deliver to Beneficiary within thirty (30) days after the date upon which any Imposition is due and payable by Trustor official receipts of the appropriate taxing authority, or other proof satisfactory to Beneficiary, evidencing the payment thereof.

(d) Trustor shall have the right before any delinquency occurs to contest or object to the amount or validity of any Imposition by appropriate proceedings, but this shall not be deemed or construed in any way as relieving, modifying, or extending Trustor's covenant to pay any such Imposition at the time and in the manner provided in this Section 1.07, unless Trustor has given prior written notice to Beneficiary of Trustor's intent to so contest or object to an Imposition, and unless, in Beneficiary's absolute and sole discretion, (i) Trustor shall demonstrate to Beneficiary's satisfaction that the proceedings to be initiated by Trustor shall conclusively operate to prevent the sale of the Trust Estate or any part thereof or interest therein to satisfy such Imposition prior to final determination of such proceedings, (ii) Trustor shall furnish a good and sufficient bond or surety as requested by and satisfactory to Beneficiary, or (iii) Trustor shall demonstrate to Beneficiary's satisfaction that Trustor has provided a good and sufficient undertaking as may be required or permitted by law to accomplish a stay of any such sale.

(e) Upon the occurrence and during the continuation of an Event of Default and upon request by Beneficiary, Trustor shall pay to Beneficiary an initial cash deposit in an amount adequate to pay all Impositions for the ensuing tax fiscal year and shall thereafter continue to deposit with Beneficiary, in monthly installments, an amount equal to one-twelfth (1/12) of the sum of the annual Impositions reasonably estimated by Beneficiary, for the purpose of paying the installment of Impositions next due (funds deposited for this purpose are referred to as "Impositions Impounds"). In such event, Trustor further agrees to cause all bills, statements, or other documents relating to Impositions to be sent or mailed directly to Beneficiary. Upon receipt of such bills, statements, or other documents, and providing there are sufficient Impositions Impounds, Beneficiary shall timely pay such amounts as may be due thereunder out of the Impositions Impounds. If at any time and for any reason the Impositions Impounds are or will be insufficient to pay such amounts as may then or subsequently be due, Beneficiary may notify Trustor and upon such notice Trustor shall deposit immediately an amount equal to such deficiency with Beneficiary. Notwithstanding the foregoing, nothing contained herein shall cause Beneficiary to be deemed a trustee of Impositions Impounds or to be obligated to pay any amounts in excess of the amount of funds deposited with Beneficiary pursuant to this Section 1.07(e). Beneficiary may commingle Impositions Impounds with its own funds and shall not be obligated to pay any interest on any Impositions Impounds. Beneficiary may reserve for future payment of Impositions such portion of Impositions Impounds as Beneficiary may in its absolute and sole discretion deem proper. If Trustor fails to deposit with Beneficiary sums sufficient to fully pay such Impositions at least thirty (30) days before delinquency thereof, Beneficiary may, at Beneficiary's election, but without any obligation so to do, advance any amounts required

to make up the deficiency, which advances, if any, shall be secured hereby and shall be repayable to Beneficiary upon demand together with interest thereon at the Default Rate from the date of such advance, or at the option of Beneficiary the latter may, without making any advance whatever, apply any Impositions Impounds held by it upon any of the Obligations in such order as Beneficiary may determine, notwithstanding that such Obligations may not yet be due.

(f) Trustor shall not initiate or suffer to occur or exist the joint assessment of any real and personal property included in the Trust Estate or any other procedure whereby the lien of real property taxes and the lien of personal property taxes shall be assessed, levied, or charged to the Trust Estate as a single lien.

1.08 Utilities. Trustor shall pay when due all charges that are incurred by Trustor for the benefit of the Trust Estate or that may become a charge or lien against the Trust Estate for gas, electricity, water, sewer, or other services furnished to the Trust Estate.

1.09 Actions Affecting Trust Estate. Except for Excluded Claims, Trustor shall appear in and contest any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee; and shall pay all costs and expenses (including, without limitation, costs of evidence of title, litigation, and attorneys' fees) in any such action or proceeding in which Beneficiary or Trustee may appear.

1.10 Actions By Trustee or Beneficiary. If either Borrower or Trustor fails to make any payment or to do any act as and in the manner provided in any of the Financing Documents, Beneficiary and/or Trustee, each in its absolute and sole discretion, without obligation so to do, without releasing Trustor from any obligation, and with only such notice to or demand upon Trustor as may be reasonable under the then existing circumstances, but in no event exceeding ten (10) days prior written notice, may make or do the same in such manner and to such extent as either may deem necessary or appropriate. In connection therewith (without limiting their general powers, whether conferred herein, in another Financing Document or by law), Beneficiary and Trustee shall have and are hereby given the right, but not the obligation, (a) to enter upon and take possession of the Trust Estate; (b) to make additions, alterations, repairs and improvements to the Trust Estate that they or either of them may consider necessary or appropriate to keep the Trust Estate in good condition and repair; (c) to appear and participate in any action or proceeding affecting or which may affect the security hereof or the rights or powers of Beneficiary or Trustee; (d) to pay, purchase, contest or compromise any Lien or Encumbrance (as defined below) or alleged Lien or Encumbrance whether superior or junior to this Deed of Trust; and (e) in exercising such powers, to pay necessary expenses (including, without limitation, expenses of employment of counsel or other necessary or desirable consultants). Trustor shall, immediately upon demand therefor by Beneficiary and Trustee or either of them, pay to Beneficiary and Trustee an amount equal to all respective costs and expenses incurred by them in connection with the exercise by either Beneficiary or Trustee or both of the foregoing rights (including, without limitation, costs of evidence of title, court costs, appraisals, surveys and receiver's, trustee's and attorneys' fees) together with interest thereon from the date of such expenditures at the Default Rate.

1.11 Transfer of Trust Estate by Trustor. Trustor agrees that, in the event of any Transfer (as hereinafter defined), without the prior written consent of Beneficiary, Beneficiary shall have the absolute right, without prior demand or notice, to declare all sums secured hereby immediately due and payable. Consent to one such transaction shall not be deemed to be a waiver of the right to require consent to future or successive transactions. Beneficiary may grant or deny such consent in its sole discretion and, if consent should be given, any such Transfer shall be subject to this Deed of Trust, and such transferee shall assume all obligations hereunder and agree to be bound by all provisions contained herein. Such assumption shall not, however, release Trustor or any maker or guarantor (if any) of the Notes from any liability thereunder without the prior written consent of Beneficiary. As used herein, "Transfer" shall mean:

(i) any sale, transfer, conveyance, hypothecation, encumbrance, lease or vesting of the Trust Estate or any part thereof or interest therein to or in any Person, whether voluntary, involuntary, by operation of law, or otherwise, except the Permitted Exceptions (as such term is defined in Exhibit C attached hereto and incorporated herein by reference);

(ii) any sale, transfer, assignment, conveyance, hypothecation, encumbrance or vesting of any shares of stock in Trustor to or in any Person or any consolidation or merger of Trustor into or with any Person whether voluntary, involuntary, by operation of law, or otherwise, except the Permitted Exceptions; or

(iii) the execution of any agreements to do any of the foregoing, except the Permitted Exceptions;

provided, however, that the term "Transfer" shall not include the transfer by Borrower of the capital stock of Trustor, so long as (a) such transfers are made either: (1) to entities that are controlled by, controlling or under common control with Trustor and Borrower, or (2) to other persons, provided that after giving effect to such transfers pursuant to this clause (a)(2) Borrower continues to own (free and clear of Liens and Encumbrances) at least a 51% interest in Trustor and (b) such transfers do not result in the dissolution or winding up of Trustor.

1.12 Eminent Domain.

(a) In the event that any proceeding or action be commenced for the taking of the Trust Estate, or any part thereof or interest therein, for public or quasi-public use under the power of eminent domain, condemnation (including, without limitation, inverse condemnation) or otherwise (hereinafter collectively referred to as a "Taking"), or if the same be taken or damaged by reason of any public improvement or Taking, or should Trustor receive any notice or other information regarding such Taking or damage, Trustor shall give prompt written notice thereof to Beneficiary. All compensation, awards, damages, rights of action and proceeds awarded to Trustor by reason of any such Taking or damage or received by Trustor as the result of a transfer in lieu of a Taking (the "Condemnation Proceeds") are hereby assigned to Beneficiary, and Trustor agrees to execute such further assignments of the Condemnation Proceeds as Beneficiary or Trustee may require. If Trustor receives any Condemnation Proceeds Trustor shall

promptly pay over such proceeds to Beneficiary. Beneficiary is hereby authorized and empowered by Trustor, at Beneficiary's option and in Beneficiary's sole discretion, as attorney-in-fact for Trustor, to settle, adjust, or compromise any claim for loss or damage in connection with any Taking or proposed Taking and, without regard to the adequacy of its security, to commence, appear in and prosecute in its own name and/or on behalf of Trustor any such action or proceeding arising out of or relating to a Taking or proposed Taking.

(b) Trustor shall not be excused from repairing or maintaining the Trust Estate as provided in Section 1.01 or restoring all damage or destruction to the Trust Estate, regardless of whether or not there are Condemnation Proceeds available to Trustor or whether any such Condemnation Proceeds are sufficient in amount. The application or release of the Condemnation Proceeds shall not cure or waive any default or notice of default hereunder or under any other Financing Document or invalidate any act done pursuant to such default or notice of default.

1.13 Additional Security. No other security now existing, or hereafter taken, to secure the obligations secured hereby shall be impaired or affected by the execution of this Deed of Trust. All security for the Obligations from time to time shall be taken, considered and held as cumulative. Any taking of additional security, execution of partial releases of the security, or any extension of the time of payment of, or modification of other terms of any of the Obligations shall not diminish the force, effect or lien of this Deed of Trust and shall not affect or impair the liability of any maker, guarantor, surety or endorser for the payment or performance of any of the Obligations. In the event Beneficiary at any time holds additional security for any of the Obligations, it may enforce the sale thereof or otherwise realize upon the same, at its option, either before, concurrently with, or after a sale or realization is made hereunder.

1.14 Appointment of Successor Trustee. Beneficiary may, from time to time, by a written instrument executed and acknowledged by Beneficiary, mailed to Trustor and recorded in the county in which the Trust Estate is located and by otherwise complying with the provisions of applicable law, substitute a successor or successors to any Trustee named herein or acting hereunder, and such successor(s) shall, without conveyance from the Trustee predecessor, succeed to all title, estate, rights, powers and duties of such predecessor.

1.15 Inspections. Beneficiary, and its agents, representatives officers, and employees, are authorized to enter at any reasonable time upon or in any part of the Trust Estate for the purpose of inspecting the same and for the purpose of performing any of the acts Beneficiary is authorized to perform hereunder or under the terms of any of the Financing Documents.

1.16 Ownership and Liens and Encumbrances. Trustor is, and as to any portion of the Trust Estate acquired hereafter will upon such acquisitions be, and shall remain the owner of the Trust Estate free and clear of any Liens and Encumbrances. Trustor shall not grant, shall not suffer to exist, and shall pay and promptly discharge, at Trustor's cost and expense, all Liens and Encumbrances and any claims thereof upon the Trust Estate, or any part thereof or interest therein. Trustor shall notify Beneficiary immediately in writing of any Lien or Encumbrance or claim thereof. Trustor shall have the right to contest in good faith the validity of any involuntary Lien or Encumbrance, provided Trustor shall first deposit with Beneficiary a bond or other

security satisfactory to Beneficiary in such amount as Beneficiary shall reasonably require, but not more than one hundred fifty percent (150%) of the amount of the claim, and provided further that if Trustor loses such contest, Trustor shall thereafter diligently proceed to cause such Lien or Encumbrance to be removed and discharged. If Trustor shall fail to remove and discharge any Lien or Encumbrance or claim thereof, then, in addition to any other right or remedy of Beneficiary, Beneficiary may, after only such notice to Trustor as may be reasonable under the then existing circumstances, but shall not be obligated to, discharge the same, either by paying the amount claimed to be due, or by procuring the discharge of such Lien or Encumbrance by depositing in a court a bond or the amount claimed or otherwise giving security for such claim, or by procuring such discharge in such manner as is or may be prescribed by law. Trustor shall, immediately upon demand therefor by Beneficiary, pay to Beneficiary an amount equal to all costs and expenses incurred by Beneficiary in connection with the exercise by Beneficiary of the foregoing right to discharge any Lien or Encumbrance or claim thereof, together with interest thereon from the date of each such expenditure at the Default Rate. Such costs and expenses shall be secured by this Deed of Trust. "Lien or Encumbrance" and "Liens and Encumbrances" mean, respectively, each and all of the following in respect of the Trust Estate: leases, other rights to occupy or use, mortgages, deeds of trust, pledges, security agreements, assignments, assignments as security, conditional sales, title retention arrangements or agreements, conditions, covenants, and restrictions, and other charges, liens, encumbrances, or adverse interests, whether voluntarily or involuntarily created and regardless of whether prior or subordinate to any estate, right, title, or interest granted to Trustee or Beneficiary in this Deed of Trust, excluding from the foregoing the Permitted Exceptions.

1.17 Trustee's Powers. At any time, or from time to time, without liability therefor and without notice, upon written request of Beneficiary and presentation of this Deed of Trust and without affecting the personal liability of any person for payment of the Obligations or the effect of this Deed of Trust upon the remainder of said Trust Estate, Trustee may (a) reconvey any part of said Trust Estate, (b) consent in writing to the making of any map or plat thereof, (c) join in granting any easement thereon, or (d) join in any extension agreement or any agreement subordinating the lien or charge hereof.

1.18 Beneficiary's Powers. Without affecting the liability of any Person liable for the payment of the Obligations herein mentioned, and without affecting the lien or charge of this Deed of Trust upon any portion of the Trust Estate not then or theretofore released as security for the Obligations, Beneficiary may, from time to time and without notice (a) release any person so liable, (b) extend the Obligations, (c) grant other indulgences, (d) release or reconvey, or cause to be released or reconveyed, at any time at Beneficiary's option any parcel, portion or all of the Trust Estate, (e) take or release any other or additional security or any guaranty for any Obligation herein mentioned, or (f) make compositions or other arrangements with debtors in relation thereto.

1.19 Trade Names. At the request of Beneficiary from time to time, Trustor shall execute a certificate in form satisfactory to Beneficiary listing the trade names or fictitious business names under which Trustor intends to operate the Trust Estate or any business located thereon and representing and warranting that Trustor does business under no other trade names or fictitious business names with respect to the Trust Estate. Trustor shall immediately notify Beneficiary in writing of any change in said trade names or fictitious business names, and will,

upon request of Beneficiary, execute any additional financing statements and other certificates necessary to reflect the change in trade names or fictitious business names.

1.20 Leasehold. If a leasehold estate constitutes a portion of the Trust Estate, Trustor agrees not to amend, modify, extend, renew or terminate such leasehold estate, any interest therein, or the lease granting such leasehold estate without the prior written consent of Beneficiary, which consent may be withheld by Beneficiary in its absolute and sole discretion. Consent to one amendment, modification, extension or renewal shall not be deemed to be a waiver of the right to require consent to other, future or successive amendments, modifications, extensions or renewals. Trustor agrees to perform all obligations and agreements under said leasehold and shall not take any action or omit to take any action which would effect or permit the termination of said leasehold. Trustor agrees to promptly notify Beneficiary in writing with respect to any default or alleged default by any party thereto and to deliver to Beneficiary copies of all notices, demands, complaints or other communications received or given by Trustor with respect to any such default or alleged default. Beneficiary shall have the option to cure any such default and to perform any or all of Trustor's obligations thereunder. All sums expended by Beneficiary in curing any such default shall be secured hereby and shall be immediately due and payable without demand or notice and shall bear interest from date of expenditure at the Default Rate.

1.21 Environmental Matters. Trustor shall not use, generate, manufacture, store or dispose of, in, under or about the Trust Estate or transport to or from the Trust Estate any Hazardous Materials, except for those Hazardous Materials used, generated, manufactured, stored or disposed of in material compliance with all applicable Environmental Laws. For purposes of this Deed of Trust, "Environmental Laws" shall mean all federal, state or local laws, whether common law, statute, ordinance, rule, regulation, or judicial or administrative decision or policy or guideline, pertaining to Hazardous Materials, health, industrial hygiene, environmental conditions, or the regulation or protection of the environment, and all amendments thereto as of this date and to be added in the future and any successor statute or rule or regulation promulgated thereto. For purposes of this Deed of Trust, "Hazardous Materials" shall include, but shall not be limited to (i) flammable explosives, radioactive materials, hazardous wastes, toxic substances or related materials, (ii) all substances defined as "hazardous substances," "hazardous materials," or "toxic substances" in the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended, 42 U.S.C. §9601, et seq.; the Hazardous Materials Transportation Act, 49 U.S.C. §1901, et seq.; the Resource Conservation and Recovery Act, 42 U.S.C. §6901, et seq.; and (iii) all substances defined as "hazardous substances" in Arizona Revised Statutes §49-201 (16). Except for the use, generation, storage, release, threatened release, discharge, or disposal of Hazardous Materials on, under or about the Trust Estate attributable to (a) Beneficiary's prior ownership of the Trust Estate, (b) Beneficiary's operation of the Trust Estate or (c) Beneficiary's operations on property adjacent to the Trust Estate, Trustor shall be solely responsible for, and shall indemnify and hold harmless Beneficiary, its directors, officers, employees, agents, successors and assigns from and against, any loss, damage, cost, expense or liability directly or indirectly arising out of or attributable to the use, generation, storage, release, threatened release, discharge, disposal, or presence of Hazardous Materials on, under or about the Trust Estate, including without limitation: (1) all foreseeable consequential damage; (2) the costs of any required or necessary repairs, cleanup or detoxification of the Trust Estate, and the preparation and implementation of any closure,

remedial or other required plans; and (3) all reasonable costs and expenses incurred by Beneficiary in connection with clauses (1) and (2), including but not limited to reasonable attorneys' fees. Beneficiary, or its agents, shall have the right to enter onto the Trust Estate to inspect the Premises and to perform any testing of the Trust Estate for the existence of Hazardous Materials and to determine compliance with all environmental laws. Any such inspection by Beneficiary shall not relieve Trustor of its obligations to comply with any such environmental law, rule or regulation.

1.22 Rights of Beneficiary. With respect to the Obligations, Trustor authorizes Beneficiary to perform any or all of the following acts at any time in its sole discretion, all without notice to or the consent or approval of Trustor and without affecting Trustor's obligations under this Deed of Trust:

(a) Beneficiary may alter any Obligation, including renewing, compromising, extending or accelerating, or otherwise changing the time for payment of, or increasing or decreasing the rate of interest on, all or any part of any Obligation.

(b) Beneficiary may take and hold security for any Obligation, accept additional or substituted security therefor, and subordinate, exchange, enforce, waive, release, compromise, fail to perfect, and sell or otherwise dispose of any such security.

(c) Beneficiary may direct the order and manner of any public or private sale of all or any part of any security assigned to Beneficiary by Borrower or any other person, or otherwise to comply with the Uniform Commercial Code of Arizona with respect to any personal property collateral, and Beneficiary may also bid at any such sale.

(d) Beneficiary may apply any payments or recoveries from Borrower, any guarantor (a "Guarantor") of any Obligation or any other source, and any proceeds of any security, to the Obligations in such manner, order and priority as Beneficiary may elect, whether or not those obligations are secured at the time of the application.

(e) Beneficiary may release Borrower or any other person of its liability for all or any part of any Obligation.

(f) Beneficiary may substitute, add, or release any one or more Guarantors or endorsers.

(g) In addition to the Obligations, Beneficiary may extend other credit to Borrower, and may take and hold security for the credit so extended, all without affecting Trustor's liability under this Deed of Trust.

1.23 Trustor's Waivers. Trustor waives:

(a) Any right it may have to require Beneficiary to proceed against Borrower or any other person, proceed against or exhaust any security held from Borrower or any other person, or pursue any other remedy in Beneficiary's power to pursue;

(b) Any defense based on any claim that Trustor's obligations exceed or are more burdensome than those of Borrower;

(c) Any defense based on (i) any legal disability of Borrower or any other Person, (ii) any release, discharge, modification, impairment, or limitation of the liability of Borrower or any other person to Beneficiary from any cause, whether consented to by Beneficiary or arising by operation of law or from any bankruptcy or other voluntary or involuntary proceeding, in or out of court, for the adjustment of debtor-creditor relationships ("Insolvency Proceeding"), and (iii) any rejection or disaffirmance of all or any part of any Obligation, or any security therefor, in any such Insolvency Proceeding;

(d) Any defense based on any action taken or omitted by Beneficiary in any Insolvency Proceeding involving Borrower, including any election to have Beneficiary's claim allowed as being secured, partially secured or unsecured, any extension of credit by Beneficiary to Borrower in any Insolvency Proceeding, and the taking and holding by Beneficiary of any security for any such extension of credit;

(e) All presentments, demands for performance, notices of nonperformance, protests, notices of protest, notices of dishonor, and of the existence, creation, or incurring of new or additional indebtedness, and demands and notices of every kind;

(f) Any defense based on or arising out of any defense that Borrower may have to the payment or performance of all or any part of any Obligation;

(g) Any defense based on the unenforceability or invalidity of any collateral assignment or guaranty with respect to any Obligation, or the lack of perfection or continuing perfection or lack of priority of any lien (other than the lien of this Deed of Trust) which secures any Obligation; and

(h) Any failure of Beneficiary to marshal assets in favor of Trustor or any other person.

1.24 Information Regarding Borrower and the Property. Trustor warrants and agrees that Trustor has not relied, and will not rely, on any representations and warranties by Beneficiary to Trustor with respect to the creditworthiness of Borrower or the prospects of repayment of any Obligation from sources other than the Trust Estate. Before signing this Deed of Trust, Trustor will have investigated the financial condition and business operations of Borrower, the present and former condition, uses and ownership of the Trust Estate, and such other matters as Trustor may deem appropriate to assure itself of Borrower's ability to discharge its obligations under or with respect to the Obligations. Trustor assumes full responsibility for such due diligence, as well as for keeping informed of all matters which may affect Borrower's ability to pay and perform its obligations to Beneficiary. Beneficiary has no duty to disclose to Trustor any information which Beneficiary may have or receive about Borrower's financial condition or business operations, the condition or uses of any of the Trust Estate, or any other circumstances bearing on Borrower's ability to perform. Trustor is familiar with the terms and conditions of the Loan Documents and consents to all provisions thereof.

1.25 Subordination. Any rights of Trustor, whether now existing or later arising, to receive payment on account of any indebtedness (including interest) owed to it by Borrower or any subsequent owner of any of the Trust Estate, or to withdraw capital invested by it in Borrower (if applicable), or to receive distributions from Borrower (if applicable), shall at all times be subordinate as to lien and time of payment and in all other respects to the full and prior repayment to Beneficiary of all Obligations; provided, however, that prior to the occurrence of an Event of Default, Trustor may receive payments of such subordinated obligations in the ordinary course of business and in a manner that is consistent with past practices.

1.26 Consideration.

(a) Trustor acknowledges that it expects to benefit from Beneficiary's entering into certain material transactions with respect to the Obligations because of Trustor's relationship to Borrower, and that it is executing this Deed of Trust in consideration of such anticipated benefit.

(b) Trustor does not intend to defraud any of its creditors by execution and delivery of this Deed of Trust. Trustor is not insolvent, and Trustor shall not be rendered insolvent by virtue of such execution of this Deed of Trust. Trustor has determined that, in its opinion, the fair market value of the benefits to be derived by it from such execution of this Deed of Trust will equal or exceed the cost and expense that may be incurred by Trustor under or in connection with this Deed of Trust.

1.27 Lawfulness and Reasonableness. Trustor warrants that all of the waivers in this Deed of Trust are made with full knowledge of their significance, and of the fact that events giving rise to any defense or other benefit waived by Trustor may destroy or impair rights which Trustor would otherwise have against Beneficiary, Borrower and other persons, or against collateral. Trustor agrees that (i) all such waivers are reasonable under the circumstances and (ii) if any such waiver is determined (by a court of competent jurisdiction) to be contrary to any law or public policy, the other waivers herein shall nonetheless remain in full force and effect.

1.28 Limitation on Amount Obligated; Contribution by Other Persons. Anything contained in this Deed of Trust to the contrary notwithstanding, if any Fraudulent Transfer Law (as hereinafter defined) is determined by a court of competent jurisdiction to be applicable to the obligations of Trustor under this Deed of Trust, such obligations shall be limited to a maximum aggregate amount equal to the largest amount that would not render Trustor's obligations under this Deed of Trust subject to avoidance as a fraudulent transfer or conveyance under Section 548 of Title 11 of the United States Code or any applicable provisions of comparable state law (collectively, the "Fraudulent Transfer Laws"), in each case after giving effect to all other liabilities of Trustor, contingent or otherwise, that are relevant under the Fraudulent Transfer Laws (specifically excluding, however, any liabilities of Trustor in respect of intercompany indebtedness, if any, to Borrower or any Affiliate (as defined in the Loan Agreement) of Borrower to the extent that such indebtedness would be discharged in an amount equal to the amount paid by Trustor under this Deed of Trust pursuant to which the liability of Trustor under this Deed of Trust is included in the liabilities taken into account in determining such maximum amount) and after giving effect as assets to the value (as determined under the applicable provisions of the Fraudulent Transfer Laws) of any rights to subrogation, reimbursement,

indemnification, or contribution of Trustor pursuant to applicable law or pursuant to the terms of any agreement.

1.29 Enforceability. Trustor hereby acknowledges that (i) the obligations undertaken by Trustor in this Deed of Trust are complex in nature, (ii) numerous possible defenses to the enforceability of these obligations may presently exist and/or may arise hereafter, (iii) as part of Beneficiary's consideration for accepting this Deed of Trust as security for advances to be made with respect to the Loan, Beneficiary has specifically bargained for the waiver and relinquishment by Trustor of all such defenses, and (iv) Trustor has had the opportunity to seek and receive legal advice from skilled legal counsel in the area of financial transactions of the type contemplated herein. Given all of the above, Trustor hereby represents and confirms to Beneficiary that Trustor is fully informed regarding, and that Trustor does thoroughly understand, (w) the nature of all such possible defenses, (x) the circumstances under which such defenses may arise, (y) the benefits which such defenses might confer upon Trustor, and (z) the legal consequences to Trustor of waiving such defenses. Trustor acknowledges that Trustor enters into this Deed of Trust with the intent that this Deed of Trust and all of the informed waivers in this Deed of Trust shall each and all be fully enforceable by Beneficiary, and that Beneficiary is accepting this Deed of Trust in material reliance upon the presumed full enforceability thereof.

1.30 No Personal Obligation. Beneficiary agrees that (i) Trustor shall have no personal liability with respect to the Obligations and (ii) Beneficiary's recourse against Trustor for the Obligations shall be limited to Beneficiary's enforcement of its remedies against the Trust Estate as encumbered by this Deed of Trust.

## ARTICLE II
## ASSIGNMENT OF RENTS

2.01 Assignment of Rents. Trustor hereby absolutely and irrevocably assigns and transfers to Beneficiary all the Rents of the Trust Estate, and hereby gives to and confers upon Beneficiary the right, power and authority to collect the Rents. Trustor irrevocably appoints Beneficiary its true and lawful attorney-in-fact, at the option of Beneficiary at any time and from time to time, to demand, receive and enforce payment, to give receipts, releases and satisfactions, and to sue, in the name of Trustor or Beneficiary, for all Rents and apply the same to the payment of the Obligations in such order as Beneficiary shall determine. Trustor hereby authorizes and directs the lessees, tenants and occupants to make all payments under the Leases directly to Beneficiary upon written demand by Beneficiary, without further consent of Trustor; provided, however, that Trustor shall have the right to collect such Rents (but not more than one (1) month in advance unless the written approval of Beneficiary is first obtained), and to retain and enjoy same, so long as an Event of Default shall not have occurred hereunder or under the other Financing Documents. The assignment of the Rents of the Trust Estate in this Article II is intended to be an absolute assignment from Trustor to Beneficiary and not merely the passing of a security interest.

2.02 Collection Upon an Event of Default. Upon the occurrence of an Event of Default, Beneficiary may, at any time without notice, either in person, by agent or by a receiver appointed by a court, and without regard to the adequacy of any security for the Obligations, enter upon and take possession of the Trust Estate, or any part thereof, and, with or without such entry or taking possession, in its own name sue for or otherwise collect the Rents (including, without limitation, those past due and unpaid) and apply the same, less costs and expenses of operation and collection (including, without limitation, attorneys' fees) upon payment of the Obligations in such order as Beneficiary may determine. The collection of such Rents, or the entering upon and taking possession of the Trust Estate, or the application of the Rents as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done in response to such default or pursuant to such notice of default. Trustor also hereby authorizes Beneficiary upon such entry, at its option, to take over and assume the management, operation and maintenance of the Trust Estate and to perform all acts Beneficiary in its sole discretion deems necessary and proper and to expend such sums out of Rents as may be needed in connection therewith, in the same manner and to the same extent as Trustor theretofore could do (including, without limitation, the right to enter into new leases, to cancel, surrender, alter or amend the terms of, and/or renew existing leases and/or to make concessions to tenants). Trustor hereby releases all claims of any kind or nature against Beneficiary arising out of such management, operation and maintenance, excepting the liability of Beneficiary to account as hereinafter set forth.

2.03 Application of Rents. Upon such entry, Beneficiary shall, after payment of all property charges and expenses (including, without limitation, reasonable compensation to such managing agent as it may select and employ) and after the accumulation of a reserve to meet requisite amounts, credit the net amount of the Rents received by it to the Obligations, but the manner of the application of such net income and which items shall be credited shall be determined in the sole discretion of Beneficiary. Beneficiary shall not be accountable for more monies than it actually receives from the Trust Estate; nor shall it be liable for failure to collect Rents. Beneficiary shall make reasonable efforts to collect Rents, reserving, however, within its own absolute and sole discretion, the right to determine the method of collection and the extent to which enforcement of collection of Rents shall be prosecuted and Beneficiary's judgment shall be deemed conclusive and reasonable.

2.04 Mortgagee in Possession. It is not the intention of the parties hereto that an entry by Beneficiary upon the Premises under the terms of this instrument shall make Beneficiary a party in possession in contemplation of the law, except at the option of Beneficiary.

2.05 Indemnity. Except for those losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs, and expenses resulting from Beneficiary's gross negligence or willful misconduct, Trustor hereby agrees to indemnify and hold harmless Beneficiary for, from and against any and all losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs, and expenses, including legal fees and expenses, howsoever and by whomsoever asserted, arising out of or in any way connected with this assignment; and all such losses, liabilities, obligations, claims, demands, damages, penalties, judgments, costs and expenses shall be deemed added to the indebtedness secured hereby and shall be secured by any and all other instruments securing said indebtedness.

2.06 No Obligation to Perform. Nothing contained herein shall operate or be construed to obligate Beneficiary to perform any obligations of Trustor under any Lease (including, without limitation, any obligation arising out of any covenant of quiet enjoyment therein contained in the event the lessee under any such Lease shall have been joined as a party defendant in any action to foreclose and the estate of such lessee shall have been thereby terminated). Prior to actual entry into and taking possession of the Premises by Beneficiary, this assignment shall not operate to place upon Beneficiary any responsibility for the operation, control, care, management or repair of the Trust Estate or any portion thereof, and the execution of this assignment by Trustor shall constitute conclusive evidence that all responsibility for the operation, control, care, management and repair of the Trust Estate is and shall be that of Trustor, prior to such actual entry and taking of possession.

## ARTICLE III
## SECURITY AGREEMENT

3.01 Creation of Security Interest. Trustor hereby grants to Beneficiary, a security interest in and to all the Personal Property.

3.02 Representations, Warranties and Covenants of Trustor. Trustor hereby represents, warrants and covenants (which representations, warranties and covenants shall survive creation of any indebtedness of Trustor to Beneficiary and any extension of credit thereunder) as follows:

(a) The Personal Property is not used or bought for personal, family or household purposes.

(b) The tangible portion of the Personal Property will be kept on or at the Premises or Improvements and Trustor will not, without the prior written consent of Beneficiary, remove the Personal Property or any portion thereof therefrom except such portions or items of Personal Property which are consumed or worn out in ordinary usage, all of which shall be promptly replaced by Trustor with similar items of equal to or greater value.

(c) Trustor hereby authorizes Beneficiary to file and/or record financing statements and fixture filings pursuant to the Uniform Commercial Code of Arizona as in effect in the State of Arizona (Arizona Revised Statutes ("A.R.S.") Sections 47-1101 through 47-11107, as amended from time to time ("Uniform Commercial Code of Arizona")), in form satisfactory to Beneficiary and will pay the cost of recording and filing the same in all public offices wherever recording or filing is deemed by Beneficiary to be necessary or desirable.

(d) Trustor's principal place of business is in the State of Arizona at 400 North 5th Street, Phoenix, Arizona 85004. Trustor does not do business under any trade name except as previously disclosed in writing to Beneficiary. Trustor will immediately notify Beneficiary in writing of any change in its place of business or the adoption or change of any trade name or fictitious business name, and will upon request of Beneficiary, execute any additional financing statements or other certificates necessary to reflect the adoption or change in trade name or fictitious business name.

(e) Trustor shall immediately notify Beneficiary of any claim against the Personal Property adverse to the interest of Beneficiary therein.

3.03 Use of Personal Property by Trustor. Until the occurrence of an Event of Default hereunder or under any other Financing Document, Trustor may have possession of the Personal Property and use it in any lawful manner not inconsistent with this Deed of Trust and not inconsistent with any policy of insurance thereon.

3.04 Remedies Upon an Event of Default.

(a) In addition to the remedies provided in Section 4.02 hereof, upon the occurrence of an Event of Default hereunder, Beneficiary may do any one or more of the following:

(i) Either personally, or by means of a court appointed receiver, take possession of all or any of the Personal Property and exclude therefrom Trustor and all others claiming under Trustor, and thereafter hold, store, use, operate, manage, maintain and control, make repairs, replacements, alterations, additions and improvements to and exercise all rights and powers of Trustor with respect to the Personal Property or any part thereof. In the event Beneficiary demands, or attempts to take possession of the Personal Property in the exercise of any rights under this Deed of Trust, Trustor agrees to promptly turn over and deliver possession thereof to Beneficiary;

(ii) Without notice to or demand upon Trustor, make such payments and do such acts as Beneficiary may deem necessary to protect its security interest in the Personal Property (including, without limitation, paying, purchasing, contesting or compromising any Lien or Encumbrance, whether superior or inferior to such security interest) and in exercising any such powers or authority to pay all expenses (including, without limitation, litigation costs and reasonable attorney's fees) incurred in connection therewith;

(iii) Require Trustor from time to time to assemble the Personal Property, or any portion thereof, at a place designated by Beneficiary and reasonably convenient to both parties, and deliver promptly such Personal Property to Beneficiary, or an agent or representative designated by Beneficiary. Beneficiary, and its agents and representatives, shall have the right to enter upon any or all of Trustor's premises and property to exercise Beneficiary's rights hereunder;

(iv) Realize upon the Personal Property or any part thereof as herein provided or in any manner permitted by law and exercise any and all of the other rights and remedies conferred upon Beneficiary by this Deed of Trust, any other Financing Document, or by law, either concurrently or in such order as Beneficiary may determine;

(v) Sell or cause to be sold in such order as Beneficiary may determine, as a whole or in such parcels as Beneficiary may determine, the Personal Property and the remainder of the Trust Estate;

(vi) Sell, lease, or otherwise dispose of the Personal Property at public sale, upon terms and in such manner as Beneficiary may determine. Beneficiary may be a purchaser at any sale; and

(vii) Exercise any remedies of a secured party under the Uniform Commercial Code of Arizona or any other applicable law.

(b) Unless the Personal Property is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, Beneficiary shall give Trustor at least five (5) days' prior written notice of the time and place of any public sale of the Personal Property or other intended disposition thereof to be made. Such notice may be mailed to Trustor at the address set forth in Section 5.05.

(c) The proceeds of any sale under Section 3.04(a)(iv) shall be applied, unless otherwise directed by statute, as provided in Clause 7 of the Agency and Disbursement Agreement. Beneficiary shall have the right to enforce one or more remedies hereunder, successively or concurrently, and such action shall not operate to estop or prevent Beneficiary from pursuing any further remedy that it may have. Any repossession or retaking or sale of the Personal Property pursuant to the terms hereof shall not operate to release Trustor until full payment of any deficiency has been made in cash.

3.05 Security Agreement. This Deed of Trust constitutes and shall be deemed to be a "security agreement" for all purposes of the Uniform Commercial Code of Arizona and Beneficiary shall be entitled to all the rights and remedies of a "secured party" under such Uniform Commercial Code of Arizona.

3.06 Fixture Filing. Upon its recording in the real property records, this Deed of Trust shall be effective as a financing statement filed as a fixture filing. In addition, a carbon, photographic or other reproduced copy of this Deed of Trust and/or any financing statement relating hereto shall be sufficient for filing and/or recording as a financing statement. The filing of any other financing statement relating to any personal property, rights or interests described herein shall not be construed to diminish any right or priority hereunder.

## ARTICLE IV
## REMEDIES UPON DEFAULT

4.01 Events of Default. An Event of Default under the Loan Agreement shall be an Event of Default hereunder.

4.02 Acceleration Upon Default; Additional Remedies. Upon the occurrence of an Event of Default, Beneficiary may declare all or any part of the Obligations immediately due and payable without any presentment, demand, protest or notice of any kind. Beneficiary may, in addition to the exercise of any or all of the remedies specified in Section 3.04:

(a) Either in person or by agent, with or without bringing any action or proceeding, or by a receiver appointed by a court and without regard to the adequacy of its security, enter upon and take possession of the Trust Estate, or any part thereof, in its own name or in the name of Trustee, and do any acts that it deems necessary or desirable to preserve the value, marketability or rentability of the Trust Estate, or any part thereof or interest therein, increase the income therefrom or protect the security hereof and, with or without taking possession of the Trust Estate, sue for or otherwise collect the Rents, or any part thereof, including, without limitation, those past due and unpaid, and apply the same, less costs and expenses of operation and collection (including, without limitation, attorneys' fees) upon the Obligations, all in such order as Beneficiary may determine. The entering upon and taking possession of the Trust Estate, the collection of such Rents and the application thereof as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done in response to such default or pursuant to such notice of default and, notwithstanding the continuance in possession of all or any portion of the Trust Estate or the collection, receipt and application of Rents, Trustee or Beneficiary shall be entitled to exercise every right provided for in any of the Financing Documents or by law upon occurrence of any Event of Default, including, without limitation, the right to exercise the power of sale;

(b) Commence an action to foreclose the lien of this Deed of Trust as a mortgage, appoint a receiver, or specifically enforce any of the covenants hereof;

(c) Exercise of the power of sale herein contained and deliver to Trustee a written statement of breach, notice of default and election to cause Trustor's interest in the Trust Estate to be sold; or

(d) Exercise all other rights and remedies provided herein, in any Financing Document or other document or agreement now or hereafter securing or guarantying all or any portion of the Obligations, or by law, including, without limitation, the rights and remedies provided in A.R.S. Section 33-702.B.

4.03 Exercise of Power of Sale. If Beneficiary elects to exercise the power of sale herein contained, Beneficiary shall notify Trustee and shall deposit with Trustee this Deed of Trust and the Notes and such receipts and evidence of expenditures made and secured hereby as Trustee may require.

(a) Upon receipt of such statement and notice from Beneficiary, Trustee shall cause to be recorded, published and delivered to Trustor such Notice of Sale as then required by law. Trustee shall, without demand on Trustor, after lapse of such time as may then be required by law and after recordation of such Notice of Sale and Notice of Sale having been given as required by law, sell the Trust Estate at the time and place of sale fixed by it in said Notice of Sale, either as a whole, or in separate lots or parcels or items as Trustee shall deem expedient, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money of the United States payable at the time of sale. Trustee shall deliver to such purchaser or purchasers thereof its good and sufficient deed or deeds conveying the property so sold, but without any covenant or warranty, express or implied. The recitals in such deed of any matters or facts shall be

conclusive proof of the truthfulness thereof. Any person, including, without limitation, Trustor, Trustee or Beneficiary, may purchase at such sale and Trustor hereby covenants to warrant and defend the title of such purchaser or purchasers.

(b) After deducting all costs, fees and expenses of Trustee and of this Trust, including, without limitation, Trustee's fees and reasonable attorneys' fees, and costs of evidence of title in connection with sale, Trustee shall apply the proceeds of sale, unless otherwise directed by statute, in accordance with Clause 7 of the Agency and Disbursement Agreement.

(c) Subject to A.R.S. Section 33-810.B, Trustee may postpone sale of all or any portion of the Trust Estate by public announcement at such time and place of sale, and from time to time thereafter may postpone such sale by public announcement or subsequently noticed sale, and without further notice make such sale at the time fixed by the last postponement, or may, in it discretion, give a new notice of sale.

4.04 Personal Property. It is the express understanding and intent of the parties that as to any personal property interests subject to Chapter 9 of the Uniform Commercial Code of Arizona, Beneficiary, upon an Event of Default, may proceed under such Uniform Commercial Code of Arizona or may proceed as to both real and personal property interests in accordance with the provisions of this Deed of Trust and its rights and remedies in respect to real property, as specifically permitted under A.R.S. Section 47-9604.A, and treat both real and personal property interests as one parcel or package of security.

4.05 Appointment of Receiver. Upon the occurrence of an Event of Default, Beneficiary, as a matter of right and without notice to Trustor or any one claiming under Trustor, and without regard to the then value of the Trust Estate or the interest of Trustor therein, shall have the right to apply to any court having jurisdiction to appoint a receiver or receivers of the Trust Estate, and Trustor hereby irrevocably consents to such appointment and waives notice of any application therefor. Any such receiver or receivers shall have all the usual powers and duties of receivers in like or similar cases and all the powers and duties of Beneficiary in case of entry as provided herein and shall continue as such and exercise all such powers until the later of the date of confirmation of sale of the Trust Estate or the date of expiration of any redemption period unless such receivership is sooner terminated.

4.06 Remedies Not Exclusive. Trustee and Beneficiary, and each of them, shall be entitled to enforce payment and performance of any and all of the Obligations and to exercise all rights and powers under the Financing Documents and under the law now or hereafter in effect, notwithstanding some or all of the Obligations may now or hereafter be otherwise secured or guaranteed. Neither the acceptance of this Deed of Trust nor its enforcement, whether by court action or pursuant to the power of sale or other rights herein contained, shall prejudice or in any manner affect Trustee's or Beneficiary's right to realize upon or enforce any other security or guaranty now or hereafter held by Trustee or Beneficiary, it being agreed that Trustee and Beneficiary, and each of them shall be entitled to enforce this Deed of Trust and any other security or any guaranty now or hereafter held by Beneficiary or Trustee in such order and manner as they or either of them may in their absolute discretion determine. No remedy herein conferred upon or reserved to Trustee or Beneficiary is intended to be exclusive of any other

remedy herein or by law provided or permitted, but each shall be cumulative and shall be in addition to every other remedy given hereunder or now or hereafter existing under the law. Every power or remedy given by any of the Financing Documents or by law to Trustee or Beneficiary or to which either of them may be otherwise entitled, may be exercised, concurrently or independently, from time to time and as often as may be deemed expedient by Trustee or Beneficiary and, to the extent permitted by law, either of them may pursue inconsistent remedies.

4.07 Request for Notice. Trustor hereby requests a copy of any notice of default and that any notice of sale hereunder be mailed to it at the address set forth in Section 5.05.

## ARTICLE V
## MISCELLANEOUS

5.01 Change, Discharge, Termination, or Waiver. No provision of this Deed of Trust may be changed, discharged, terminated, or waived except in a writing signed by the party against whom enforcement of the change, discharge, termination, or waiver is sought. No failure on the part of Beneficiary to exercise and no delay by Beneficiary in exercising any right or remedy under the Financing Documents or under the law shall operate as a waiver thereof.

5.02 Trustor Waiver of Rights. Trustor waives, to the extent permitted by law, (a) the benefit of all laws now existing or that may hereafter be enacted providing for any appraisement before sale of any portion of the Trust Estate, and (b) all rights of redemption, valuation, appraisement, stay of execution, notice of election to mature or declare due the Obligations and marshaling in the event of foreclosure of the liens hereby created, and (c) all rights and remedies that Trustor may have or be able to assert by reason of the laws of the State of Arizona pertaining to the rights and remedies of sureties including, without limitation, A.R.S. Sections 12-1641 through 12-1646, and Arizona Rules of Civil Procedure 17(f).

5.03 Statements by Trustor. Trustor shall, within ten (10) days after written notice thereof from Beneficiary, deliver to Beneficiary a written statement stating the unpaid principal of and interest on the Notes and any other amounts secured by this Deed of Trust and stating whether any offset or defense exists against such principal and interest or such other amounts.

5.04 Reconveyance by Trustee. Upon written request of Beneficiary stating that all Obligations have been satisfied in full, and upon surrender of this Deed of Trust and the Notes to Trustee for cancellation and retention and upon payment by Trustor of Trustee's fees, Trustee shall reconvey to Trustor, or to the person or persons legally entitled thereto, without warranty, any portion of the Trust Estate then held hereunder. The recitals in such reconveyance of any matters or facts shall be conclusive proof of the truthfulness thereof. The grantee in any reconveyance may be described as "the person or persons legally entitled thereto."

5.05 Notices. All notices, requests and demands to be made hereunder to the parties hereto shall be in writing and shall be delivered by hand or sent by registered or certified mail, return receipt requested, through the United States Postal Service to the addresses shown below or such other address which the parties may provide to one another in accordance herewith. Such notices, requests and demands, if sent by mail, shall be deemed given two (2) days after

deposit in the United States mail, and if delivered by hand, shall be deemed given when delivered.

To Beneficiary: Pinnacle West Energy Corporation
400 North 5th Street
Phoenix, Arizona 85004
Attention: Warren Kotzmann, V. P., Finance and Corporate Services
Mail Station 9988

To Trustor: Arizona Public Service Company
400 North 5th Street
Phoenix, Arizona 85004
Attention: Don Robinson, V.P., Finance and Planning
Mail Station 9909

5.06 Acceptance by Trustee. Trustee accepts this Trust when this Deed of Trust, duly executed and acknowledged, is made a public record as provided by law.

5.07 Captions and References. The headings at the beginning of each section of this Deed of Trust are solely for convenience and are not part of this Deed of Trust. Unless otherwise indicated, each reference in this Deed of Trust to a section or an exhibit is a reference to the respective section herein or exhibit hereto.

5.08 Invalidity of Certain Provisions. If any provision of this Deed of Trust is unenforceable, the enforceability of the other provisions shall not be affected and they shall remain in full force and effect. If the lien of this Deed of Trust is invalid or unenforceable as to any part of the debt, or if the lien is invalid or unenforceable as to any part of the Trust Estate, the unsecured or partially secured portion of the debt shall be completely paid prior to the payment of the remaining and secured or partially secured portion of the debt, and all payments made on the debt, whether voluntary or under foreclosure or other enforcement action or procedure, shall be considered to have been first paid on and applied to the full payment of that portion of the debt which is not secured or fully secured by the lien of this Deed of Trust.

5.09 Subrogation. To the extent that proceeds of the Notes are used to pay any outstanding lien, charge or prior encumbrance against the Trust Estate, such proceeds have been or will be advanced by Beneficiary at Trustor's request and Beneficiary shall be subrogated to any and all rights and liens held by any owner or holder of such outstanding liens, charges and prior encumbrances, irrespective of whether said liens, charges or encumbrances are released.

5.10 Attorneys' Fees. If any or all of the Obligations are not paid when due or if an Event of Default occurs, Trustor agrees to pay all costs of enforcement and collection and preparation therefore (including, without limitation, reasonable attorney's fees) whether or not any action or proceeding is brought (including, without limitation, all such costs incurred in connection with any bankruptcy, receivership, or other court proceedings (whether at the trial or appellate level)), together with interest therein from the date of demand at the Default Rate.

5.11 Governing Law. THIS DEED OF TRUST SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF ARIZONA.

5.12 Joint and Several Obligations. If this Deed of Trust is signed by more than one party as Trustor, all obligations of Trustor herein shall be the joint and several obligations of each party executing this Deed of Trust as Trustor.

5.13 Number and Gender. In this Deed of Trust the singular shall include the plural and the masculine shall include the feminine and neuter gender and vice versa, if the context so requires.

5.14 No Merger of Lease. If both the lessor's and lessee's estate under any lease or any portion thereof which constitutes a part of the Trust Estate shall at any time become vested in one owner, this Deed of Trust and the lien created hereby shall not be destroyed or terminated by application of the doctrine of merger unless Beneficiary so elects as evidenced by recording a written declaration executed by Beneficiary so stating, and, unless and until Beneficiary so elects, Beneficiary shall continue to have and enjoy all of the rights and privileges of Beneficiary as to the separate estates. In addition, upon the foreclosure of the lien created by this Deed of Trust on the Trust Estate pursuant to the provisions hereof, any leases or subleases then existing and affecting all or any portion of the Trust Estate shall not be destroyed or terminated by application of the law of merger or as a matter of law or as a result of such foreclosure unless Beneficiary or any purchaser at such foreclosure sale shall so elect. No act by or on behalf of Beneficiary or any such purchaser shall constitute a termination of any lease or sublease unless Beneficiary or such purchaser shall give written notice thereof to such tenant or subtenant.

5.15 Status of Title. Trustor represents and warrants that it is the lawful owner of the Trust Estate free and clear of all Liens and Encumbrances and holds a fee simple estate in the Premises and Improvements, subject only to the Permitted Exceptions and that Trustor has full right, power and authority to convey and mortgage the same and to execute this Deed of Trust.

5.16 Integration. The Financing Documents contain the complete understanding and agreement of Trustor and Beneficiary and supersede all prior representations, warranties, agreements, arrangements, understandings, and negotiations.

5.17 Binding Effect. The Financing Documents will be binding upon, and inure to the benefit of, Trustor, Trustee and Beneficiary and their respective successors and assigns. Trustor may not delegate its obligations under the Financing Documents.

5.18 Time of the Essence. Time is of the essence with regard to the each provision of the Financing Documents as to which time is a factor.

5.19 Survival. The representations, warranties, and covenants of the Trustor and the Financing Documents shall survive the execution and delivery of the Financing Documents.

IN WITNESS WHEREOF, Trustor has executed this Deed of Trust as of the day and year first above written.

PINNACLE WEST ENERGY CORPORATION, an Arizona corporation

By: _____
Name: Warren Kotzmann
Title: Vice President, Finance and Corporate Services

"Trustor"

STATE OF ARIZONA )
) ss.
County of Maricopa )

The foregoing instrument was acknowledged before me this 5th day of December, 2002, by Warren Kotzmann, the Vice President, Finance and Corporate Services of PINNACLE WEST ENERGY CORPORATION, An Arizona corporation, on behalf of the corporation.

Norann Asciutto
Notary Public

My commission expires:
2/12/04

OFFICIAL SEAL
NORANN ASCIUTTO
Notary Public - State of Arizona
MARICOPA COUNTY
My comm. expires Feb. 12, 20

# EXHIBIT A

## Parcel 1 - Unit 4

A parcel of land being located in the Southeast quarter of Section 9, Township 1 North, Range 2 East of the Gila and Salt River Base and Meridian, Maricopa County, Arizona. Said parcel being more particularly described as Parcel 1, Unit 4 and

COMMENCING at the South quarter corner of said section;

Thence, North 00° 18' 01" West along the West line of the Southeast quarter of Section 9, Township 1 North, Range 2 East, a distance of 1,486.38 feet;

Thence North 89° 17' 24" East a distance of 40 feet to the TRUE POINT OF BEGINNING of the parcel herein described;

Thence, continuing Northeast along the same bearing a distance of 317.26 feet, along the North line of said parcel;

Thence South 01° 11' 27' East a distance of 99.08 feet;

Thence North 89° 17' 24" East a distance of 49.43 feet;

Thence South 00' 42' 36′ East a distance of 100.14 feet;

Thence North 89° 17' 24" East a distance of 43.34 feet;

Thence South 00° 42' 36" East a distance of 105.96 feet;

Thence South 89° 20' 44" West along the South line of the parcel herein described, a distance of 412.99 feet;

Thence North 00° 18' 01" West along the West line of said parcel, a distance of 300.78 feet to the TRUE POINT OF BEGINNING of the parcel herein described, said parcel containing 2.543 acres more or less.

Parcel 2 - Unit 5

A parcel of land located in the Southeast quarter of Section 9, Township 1 North, Range 2 East of the Gila and Salt River Base and Meridian, Maricopa County, Arizona. Said parcel being more particularly described as Parcel 2, Unit 5 and

COMMENCING at the East quarter corner of said section;

Thence, South 89° 21' 48" West along the North line of the Southeast quarter of Section 9, Township 1 North, Range 2 East, a distance of 2,622.28 feet;

Thence South 00° 18' 01" East along the West line of the Southeast quarter of said section, a distance of 94.82 feet;

Thence North 89° 17' 24" East a distance of 30 feet to the TRUE POINT OF BEGINNING of the parcel herein described;

Thence, continuing Northeast along the same bearing a distance of 1,040.41 feet along the North line of said parcel;

Thence, South 45° 00' 00" East a distance of 85.85 feet;

Thence, South 00° 42' 36" East a distance of 88.39 feet;

Thence South 89° 17" 24" West a distance of 481.33 feet;

Thence South a distance of 293.07 feet;

Thence South 89° 17' 24" West a distance of 618.57 feet;

Thence North 00° 18' 01" West a distance of 442.90 feet to the TRUE POINT OF BEGINNING of the parcel herein described, said parcel containing 7.911 acres more or less.

Parcel 3 - Water Containment Area

A parcel of land located in the Southwest quarter of Section 9, Township 1 North, Range 2 East of the Gila and Salt River Base and Meridian, Maricopa County, Arizona. Said parcel being more particularly described as Parcel 3, Water Containment Area and

COMMENCING at the South quarter corner of said section;

Thence, North 00° 18' 01" West along the East line of the Southwest quarter of Section 9, Township 1 North, Range 2 East, a distance of 1,281.67 feet;

Thence, South 89° 17' 36" West a distance of 40 feet to the TRUE POINT OF BEGINNING of the parcel herein described;

Thence, continuing Southwest along the same bearing a distance of 629.09 feet along the South line of the parcel herein described;

Thence North 00° 13' 26" West along the West line of the parcel herein described, a distance of 1,123.64 feet;

Thence North 89° 21' 48" East a distance of 221.11 feet;

Thence South 00° 36' 52" East a distance of 781.97 feet;

Thence North 89° 17' 24" East a distance of 402.19 feet;

Thence South 00° 18' 01" East a distance of 341.39 feet to the TRUE POINT OF BEGINNING of the parcel herein described, said parcel containing 8.946 acres more of less.

Parcel 4 - Temporary Generator Area

A parcel of land located in the Southeast quarter of Section 9, Township 1 North, Range 2 East of the Gila and Salt River Base and Meridian, Maricopa County, Arizona. Said parcel being more particularly described as Parcel 4, Temporary Generator Area, and

COMMENCING at the Southeast corner of said section;

Thence, North 00° 03' 22" East along the East line of Section 9, Township 1 North, Range 2 East a distance of 1,359.93 feet;

Thence, South 89° 21' 48" West a distance of 40 feet to the TRUE POINT OF BEGINNING of the parcel herein described;

Thence, continuing Southwest along the same bearing a distance of 302.93 feet, along the South line of the parcel herein described;

Thence, North 00° 03' 22" East along the West line of said parcel, a distance of 669.00 feet;

Thence North 89° 21' 48" East along the North line of said parcel, a distance of 302.93 feet;

Thence South 00° 03' 22" West along the East line of said parcel, a distance of 669.00 feet to the TRUE POINT OF BEGINNING of the parcel herein described, said parcel containing 4.652 acres more or less.

EXHIBIT B

DESCRIPTION OF PERSONAL PROPERTY

(a) All personal property, (including, without limitation, all goods, supplies, equipment, furniture, furnishings, fixtures, machinery, and inventory) in which Trustor now or hereafter acquires an interest or right, which is now or hereafter located on or affixed to the Premises or the Improvements, together with all books, records, leases and other agreements, documents, and instruments of whatever kind or character, relating to the Premises, Improvements, or such personal property;

(b) All fees, income, rents, issues, profits, earnings, receipts, royalties, and revenues which, after the date hereof and while any portion of the Obligations remains unpaid or unperformed, may accrue from the personal property referenced in Paragraph (a) above, or any part thereof or from the Premises, the Improvements or any other part of the Trust Estate, or which may be received or receivable by Trustor from any hiring, using, letting, leasing, subhiring, subletting, subleasing, occupancy, operation, or use thereof;

(c) All of Trustor's present and future rights to receive payments of money, services, or property, relating to the Premises, the Improvements, or the personal property described in Paragraph (a) above including, without limitation, rights to all deposits from tenants of the Premises or Improvements, accounts and other accounts receivable, deposit accounts, chattel paper, notes, drafts, contract rights, instruments, general intangibles, and principal, interest and payments due on account of goods sold or leased, services rendered, loans made or credit extended, together with title to or interest in all agreements, documents, and instruments, evidencing, securing or guarantying the same;

(d) All other intangible property and rights relating to the Premises, the Improvements, the personal property described in Paragraph (a) above or the operation, occupancy, or use thereof, including, without limitation, all governmental and non-governmental permits, licenses, and approvals relating to construction on or operation, occupancy, or use of the Premises or Improvements, all names under or by which the Premises or Improvements may at any time be operated or known, all rights to carry on business under any such names, or any variant thereof, all trade names and trademarks relating in any way to the Premises or the Improvements, and all good will in any way relating to the Premises or the Improvements;

(e) Trustor's rights under all insurance policies covering the Premises, the Improvements, the Personal Property, and the other parts of the Trust Estate and any and all proceeds, loss payments, and premium refunds payable regarding the same;

(f) All water stock relating to the Premises;

(g) All causes of action, claims, compensation, and recoveries for any damage to, destruction of, or condemnation or taking of the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate, or for any conveyance in lieu thereof, whether direct or consequential, or for any damage or injury to the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate, or for any loss or diminution in value of the Premises, the Improvements, the Personal Property, or any other part of the Trust Estate;

(h) All architectural, structural, mechanical, and engineering plans and specifications prepared for construction of Improvements or extraction of minerals or gravel from the Premises and all studies, data, and drawings related thereto; and also all contracts and agreements of the Trustor relating to the aforesaid plans and specifications or to the aforesaid studies, data, and drawings or to the construction of Improvements on or extraction of minerals or gravel from the Premises;

(i) All proceeds from sale or disposition of any of the aforesaid collateral; and

(j) All Trustor's rights in proceeds of the loan evidenced by the Note.

(k) As used in this Exhibit B the terms "Premises", "Improvements", and "Personal Property" shall have the meanings set forth in the Deed of Trust to which this Exhibit B is attached.

# EXHIBIT C

"Permitted Exceptions" means the following:

1. Sale, transfer, or other disposition of any Personal Property that is consumed or worn out in ordinary usage and that is promptly replaced with similar items of equal or greater value.

2. Any purchase, sale, transportation, exchange, option, or similar transaction in the ordinary course of Trustor's business with respect to fuel, electricity and/or capacity, including, but not limited to, system, plant or unit contingent transactions or system, plant or unit specific tolling agreements (collectively, the "Transactions"), and the assignment of such Transactions to or from the Trustor.

3. Liens and Encumbrances being contested in accordance with Section 1.17 of the Deed of Trust.

4. Impositions being contested in accordance with Section 1.07(d) of this Deed of Trust.

5. Items recorded in the Official records of the county prior to the date of recording of this Deed of Trust.

EXHIBIT
APS-8
Admitted

# REBUTTAL TESTIMONY OF JACK E. DAVIS

**On Behalf of Arizona Public Service Company**

**Docket No. E-01345A-02-0707**

**December 30, 2002**

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**REBUTTAL TESTIMONY OF JACK E. DAVIS**
**ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY**
**(Docket No. E-01345A-02-0707)**

I. INTRODUCTION

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

A. My name is Jack E. Davis. My business address is 400 North Fifth Street, Phoenix, Arizona 85072. I am President and Chief Executive Officer for Arizona Public Service Company ("APS" or "Company"). I am also a President of Pinnacle West Capital Corporation ("PWCC").

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

A. My resume is attached as Appendix A to this testimony.

**Q. DID YOU PREVIOUSLY SUBMIT WRITTEN TESTIMONY IN THIS FINANCING PROCEEDING?**

A. No.

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

A. I very much agree with Utilities Division Staff ("Staff") witness John S. Thornton, Jr., and Residential Utility Consumer Office ("RUCO") witness Mary Lee Diaz-Cortez that granting the Application is in the public interest. I will support that conclusion by reminding the Arizona Corporation Commission ("Commission") of the origins of Pinnacle West Energy Corporation ("PWEC") and its intended relationship with Arizona Public Service Company ("APS" or "Company"). I also will defend the financing plan used to pay for PWEC's construction program from the unsupported claims of Panda Gila River, L.P. ("Panda/TECO") witness Susan Abbott. Finally, I wish to discuss the existing

regulatory insulation of APS from potential affiliate abuse and explain the APS position with regard to the Staff's proposed dividend limitation. Such a limitation is one of the conditions Staff has requested that the Commission adopt in its approval of the Company's Application.

## II. SUMMARY

**Q. COULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?**

A. In evaluating the public interest criteria discussed by both Mr. Thornton and APS witness Barbara M. Gomez, as well as other witnesses, the Commission must consider all of the benefits realized as a result of granting the Application rather than getting hung up on parsing the various specific terms used in Title 40, Arizona Revised Statutes. And it cannot be forgotten that PWEC was created as a direct result of, and would never have existed absent, the 1999 APS Settlement and the Commission's Electric Competition Rules. Its two primary purposes were to receive the APS generation units divested pursuant to that Settlement and to construct new generation for APS customers so that these customers would not be wholly dependent on the vagaries of the wholesale electric market for reliable and reasonably-priced generation. In this role, PWEC could also serve as a competitive check on that wholesale market to the long-term benefit of APS and its customers.

The financing plan that PWCC put together was intended to produce the lowest cost of constructing that generation consistent with the mandated divestiture date of December 31, 2002. That plan was reviewed and validated by independent rating agencies. It was working, and it would have continued to work had APS been allowed to divest its generation to PWEC as was originally agreed to by the Company and the Commission.

APS is subject to intense and overlapping affiliate regulation at both the state and federal level. That regulation provides significant and explicit "regulatory insulation" to APS. Indeed, the very existence of this proceeding is a prime example of that insulation—a fact that some of the witnesses and, unfortunately, some debt rating agency analysts, choose to ignore.

The APS Board of Directors is charged with setting the dividend policies of the Company. As one of those Directors, I can tell you that we take that responsibility seriously and would not agree to Staff's proposed dividend limitation unless we believed it in the interests of both APS and PWCC under the special and unique circumstances of this case. As proposed by Staff, and with the clarification suggested by Ms. Barbara Gomez in her Rebuttal Testimony, it is a condition to the approval of our Application that is acceptable.

## III. BENEFITS FROM GRANTING THE APPLICATION

**Q. PANDA/TECO WITNESS ABBOTT URGES THE COMMISSION TO DENY THE APPLICATION. WOULD YOU SUMMARIZE THE REASONS SUCH DENIAL WOULD BE INAPPROPRIATE?**

A. Yes. Granting the Application, even subject to Staff's conditions, has at least eight distinct benefits for APS and its customers. The proposed financing would:

- Avoid a downgrade of APS debt ratings
- Avoid corresponding increases in the APS cost of capital
- Strengthen wholesale competition by maintaining PWEC as a viable competitor in the upcoming Track B solicitation
- Preserve the Commission's ability to consider rate base treatment of the PWEC assets in the 2003-2004 rate case
- Strengthen investor and rating agency confidence in the Commission

- Continue a responsive and responsible regulatory environment
- Preserve the current Track B solicitation process
- Result in settlement of most of the issues in the Track A legal appeals

**Q. HAVE YOU ATTEMPTED TO MATCH THESE BENEFITS TO THE SPECIFIC LANGUAGE IN THE STATUTES AND REGULATIONS CITED BY MR. THORNTON AND MS. GOMEZ?**

A. No. I will leave that to the lawyers and these other expert witnesses. To me, all of these criteria are rolled into the public interest standard. Each of the above benefits is clearly in the public interest, and perhaps of more specific concern, in the interest of APS customers. Just as obviously, obtaining all eight of these benefits is all the more beneficial to APS and its customers.

## IV. ORIGIN, PURPOSE AND FINANCING OF PWEC

**Q. WHY IS PWEC DIFFERENT FROM OTHER MERCHANT GENERATING ENTITIES IN ARIZONA?**

A. Unlike Ms. Gomez, I was, in part, responsible for PWEC's creation. And unlike any merchant generator in Arizona (or anywhere else, for that matter), PWEC owed its existence to a Settlement Agreement between APS and the Commission itself. No entity other than PWEC had the right, or even the expectation, of acquiring the Company's generation by December 31, 2002. No merchant generator built its entire business upon the notion that it had a responsibility to plan for and subsequently serve APS customers prior to seeking markets elsewhere.

This was no hypothetical duty. PWEC, and only PWEC, constructed new generation within Metro-Phoenix to help provide the local generation needed to

reliably serve the great majority of the Company's customers. Only PWEC moved quickly to bring in temporary generation during the critical summer months of 2001—an action costing PWEC many millions of dollars and for which APS customers were asked to pay nothing. And I personally vetoed a proposal to sell forward the output of PWEC's plants to California during the 2001 "buying spree" by the California Department of Water Resources. We thus forewent a potential long-term above-cost contract that might have given PWEC the basis for independent financing.

**Q. COULD NOT PWEC SIMPLY CONTINUE AS AN INDEPENDENT MERCHANT ENTITY?**

A. Absent the requested financing, it may not continue at all. And PWEC was never envisioned as or structured to be a start-up merchant venture. That is why the present intent is to fold the Arizona part of PWEC back into APS. PWEC's very limited Nevada project (Silverhawk) could continue on with the strong partnering of the Southern Nevada Water Authority. Silverhawk also has transmission access to Phoenix and could participate in competitive power procurements by any of the Arizona utilities, including APS.

**Q. WHY WAS PWEC'S CONSTRUCTION FINANCED BY PWCC?**

A. You have to remember that APS was going out of the generation business after the 1999 Settlement, regardless of whether the Electric Competition Rules survived their ongoing legal challenge by the state's electric cooperatives and certain consumer groups. It would not have made sense to finance generation at APS. Indeed, I am sure that some would have contended that any costs incurred to thereafter transfer such new generation to PWEC were imprudent. And given the Company's existing Code of Conduct, which barred it from participating in

competitive electric activities, including generation, even prior to the scheduled December 31, 2002 divestiture, we would have had to seek some manner of variance to do so in any event.

The only other entity in the Pinnacle West group having significant financing capacity was PWCC. Although PWCC has few tangible assets, it had steady cash flows from APS and SunCor Development Company ("SunCor"), as well as a successful Marketing and Trading ("M&T") division. Rating agencies, as well as debt and equity analysts, were willing to accept high levels of PWCC debt for the short term because of the promise that the debt would eventually be unified at an operating subsidiary (then envisioned as PWEC) having both the assets and associated debt of APS' generation. That was to happen by year-end 2002 at the latest, and thus it is no mere coincidence that most of PWCC's bridge debt comes due in 2003.

**Q. WHY DIDN'Y PWEC USE PROJECT FINANCING TO SUPPORT NEW CONSTRUCTION?**

A. The better question is why use such financing if it will be more expensive, less flexible and unnecessary. Although project financing may have been available to PWEC without a PWCC guarantee and even without a long-term agreement, the cost compared with using the Bridge Debt would have been high, and this higher cost could have hurt APS consumers since they were the primary intended beneficiaries of PWEC's construction. And I am sure the banks would have had something quite negative to say about the decision not to sell PWEC's output to California in 2001. I know they also would not be waiting to see what the Commission was going to do about rate-basing the PWEC assets in the next APS rate case. We would be under tremendous pressure to the sell

these assets' output, if not the PWEC assets themselves, today regardless of whether such sales were in the best interest of APS customers.

**Q. WAS THE PWCC FINANCING OF THE PWEC ASSETS SUCCESSFUL?**

A. Yes. PWCC borrowed some three-quarters of a billion dollars with the understanding that the bulk of this would be refinanced at the operating subsidiary level in 2003. After all, at the time, PWEC had an investment grade rating that it could use post-divestiture. And PWEC fully anticipated being able to fulfill both its financial and operational role in supporting the unified generation of APS and PWEC, both of which sets of generation were built to serve APS customers.

**Q. DIDN'T THE DETERIORATION OF THE FINANCIAL MARKETS FOR GENERATION IN 2002 HAVE MORE TO DO WITH PWCC AND PWEC'S DILEMMA THAN THE ABSENCE OF DIVESTITURE?**

A. It was certainly a significant factor for PWCC, and I don't mean to underestimate the importance of the present depressed financial market for electric generation in general. If the credit markets had remained as they were in 2000 and early to mid-2001, it is possible (although by no means certain) that PWEC could have obtained refinancing for PWCC's Bridge Debt even with the limited and undiversified group of generating assets left at PWEC by Decision No. 65154. This is especially true if the opportunity presented in 2001 to forward sell these PWEC facilities' output to California had been seized upon without regard for the consequences to APS' customers. But the financial markets did change, divestiture did not occur, and PWEC remained true to its original purpose—a decision for which I do not apologize.

## V. EXISTING AFFILIATE RESTRICTIONS AND "REGULATORY INSULATION"

**Q. STAFF'S RECOMMENDATIONS STRESS THEIR BELIEF THAT "REGULATORY INSULATION" OF APS SHOULD BE STRENGTHENED. DOES THIS MEAN THAT SUCH INSULATION DOES NOT EXIST AT PRESENT?**

A. No. APS is subject to any number of restrictions that insulate the Company from the potential of affiliate abuse. The first, most obvious, and in the long run most effective insulation is this Commission's power to disallow unreasonable or imprudent costs in setting APS retail rates. Second, the Commission has imposed a general set of affiliate rules on all utility holding company organizations above a certain minimal size. Unlike virtually all the other covered utilities, APS has never received a general waiver of such affiliate rules and just this December, received its first transaction-specific waiver unrelated to the 1999 Settlement and the Electric Competition Rules. This waiver permitted APS to provide a back-up line of credit to PWCC. *See* Decision No. 65434 (December 3, 2002). Third, APS has both state and federally-mandated codes of conduct covering inter-affiliate pricing and inter-affiliate accounting for electric service affiliates such as APS Energy Services, Inc., PWEC and M&T. The Commission has also approved Policies & Procedures to implement the state Code of Conduct. Fourth, the Federal Energy Regulatory Commission has Standards of Conduct governing specific functions at APS. And this Commission is presently considering both an expanded state Code of Conduct filed in response to Decision No. 65154 and a Staff recommendation in Track B for state Standards of Conduct governing competitive power solicitation.

A. **DOES THIS APPLICATION PROVIDE EVIDENCE THAT THESE EXISTING OR PROPOSED AFFILIATE RESTRICTIONS AND THE CORRESPONDING DEGREE OF "REGULATORY INSULATION" FOR APS ARE INADEQUATE?**

A. No, quite the contrary. It is because of these various affiliate limitations that APS must come to this Commission and prove that a specific transaction or activity covered by the aforementioned restrictions is nonetheless compatible with the interests of APS and its customers. We proved this in Decision No. 65434 and have done so again in this proceeding. APS also comes to this Application out of the truly unique circumstances of Decision No. 65154, which recognized the changes in the wholesale electric market prompting, in turn, the Commission's "change of course" regarding divestiture. These are the distinguishing facts that some rating agency analysts fail to grasp. They sometimes fall into the trap of believing that having rigid sets of "one size fits all" regulations and rules can substitute for the informed judgment of local utility regulators.

Yet another practical example of "regulatory insulation" is the "self-help" program initiated by PWCC to address the remaining portion of the Bridge Debt problem described in the Company's Application and testimony. We recently issued PWCC common stock to the degree our financial people believed prudent. PWCC and PWEC are cutting and deferring expenses and capital outlays, such as the recent cancellation of Redhawk Units 3 and 4. Another non-APS affiliate, SunCor, is accelerating its sales of real estate to increase cash distributions to PWCC. We know that the $500 million loan covers only a part of the Bridge Debt and that much of this Debt will simply have to be repaid by PWCC rather than refinanced.

## VI. THE STAFF'S PROPOSED DIVIDEND LIMITATION

**Q. HAS APS AGREED TO THE STAFF'S PROPOSED DIVIDEND LIMITATION?**

A. Assuming the Application is otherwise granted subject to conditions no more onerous than proposed by Staff, the answer is yes.

**Q. WHY?**

A. The requested financing is a necessary step in what Ms. Gomez describes in her Direct testimony as "the Recovery Plan." (*See* Direct Testimony of Barbara M. Gomez at page 13, *et al.*) APS is willing to accept Staff's proposal because we believe that providing the Commission this additional assurance of our good faith and resolve to act in the best interest of APS and its customers will allow the Application to be granted.

In doing so, I must emphasize the critical importance of Staff's corollary recommendation for an expedited waiver or variance process with regard to this condition. I also agree with Ms. Gomez about the need for precision in interpreting how this provision will be implemented in practice. APS dividend limitations will not be an easy sell with PWCC investors. And as I noted above, the $500 million loan will still leave PWCC with considerable debt. We will have to show potential investors that the limitation allows the Commission the discretion to waive or modify it under specific circumstances and that the limitation is based on solid, publicly available financial data, data which is well-understood by the market.

**A. DOES APS BELIEVE THAT THE COMMISSION CAN UNILATERALLY IMPOSE DIVIDEND LIMITATIONS ON APS?**

A. No. That is a power reserved to the Company's Board of Directors subject to fiduciary obligations and legislative provisions. But there is no need to argue this point again. As we did back in 1991, when Staff also proposed a dividend limitation and litigation loomed, APS and Staff have come to a settlement on

this matter. This agreement, subject to the provisos described in response to the preceding question, allows this issue to become an interesting but moot point for the lawyers to debate.

## VII. CONCLUSION

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

A. Yes. I join Ms. Gomez in appreciating the efforts of Staff and Intervenor RUCO, both of which recognized the need for favorable action on the Company's Application. My testimony has pointed out the appropriateness of such action given the history behind the present circumstances facing APS and its affiliates, PWCC and PWEC. I also respond to those intervenors, and for that matter, those in the financial community who are either unaware of or choose to ignore both that history and the comprehensive scheme of "regulatory insulation" that already exists for APS at several levels. Even Staff's proposed dividend limitation can be properly viewed as a part of a larger plan to address the ultimate regulatory treatment of the PWEC assets. In Decision No. 65154, the Commission expressed its desire to act fairly with regard to the consequences of its "change of direction." (*See* Decision No, 65154 at page 22.) Approval of the Company's Application, subject to the conditions proposed by Staff (with the clarification or moderation discussed by Ms. Gomez) is consistent with that expression. And it will allow APS to move on to the larger issues of the 2003-2004 rate case.

**Q. DOES THAT CONCLUDE YOUR PREFILED REBUTTAL TESTIMONY IN THIS PROCEEDING?**

A. Yes, it does.

# APPENDIX A

## STATEMENT OF WITNESS QUALIFICATIONS

Jack E. Davis is President for Pinnacle West Capital Corporation (PWCC) and President and Chief Executive Officer for Arizona Public Service Company (APS). And is also on the Boards of PWCC and APS.

Mr. Davis attended New Mexico State University and received BS degrees in Medical Technology in 1969 and Electrical Engineering in 1973. He was then hired by APS as an Engineer in the System Planning Department. Subsequently, he has had positions as Administrator of Power Contracts, Manager of Power Contracts, Director of System Development and Power Operations, Director of Fossil Generation, Director of Transmission Systems, Vice President of Generation and Transmission, Chief Operating Officer for PWCC, President of PWCC and was promoted to Chief Executive Officer of APS in September of 2002.

Mr. Davis has served (i) as Chairman of the Western Systems Coordinating Council (WSCC) and is a member of its Board of Trustees; (ii) as Chairman on the Western Systems Power Pool; (iii) as President of Western Energy and Supply Transmission (WEST) Associates; and (iv) as a past member of the National Electric Reliability Council Board of Trustees. He is a registered Professional Engineer in the State of Arizona. He is also on the Boards of the Greater Phoenix Chamber of Commerce, Arizona Chamber of Commerce where he serves as Chairman, and presently serves as Chairman of the Arizona Theatre Company. He is a member of the Electrical Engineering Industry Advisory Committee at Arizona State University and the Downtown Phoenix Partnership.

ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. E-01345A-02-0707
RUCO'S 3rd SET OF DATA REQUESTS
DATED 11/18/02

EXHIBIT
APS-9
Admitted

3.5 How much of PWCC problem in refinancing the PWEC assets is attributable to the general credit markets for energy related companies and how much is attributable to the ACC's dramatic "reversal of course" on divestiture.

RESPONSE:

The problem is clearly attributable to both, and although the ACC's reversal of course was the precipitating event, it is not particularly relevant or helpful at the present time to attempt in some way to "allocate" responsibility for a single outcome to any one of its several contemporaneous causes, nor has APS attempted to do so. PWCC had planned to finance at PWEC, which after the divestiture, would have been an investment grade company. Without investment grade credit ratings, PWEC is not able to access the capital markets. This then leaves the parent in the position of having to do the refinancing which in turn could lead to credit rating downgrades. It is nevertheless also true that the general credit markets for energy related companies have been both volatile and shrinking for the past several months. There is a clear bifurcation of market participants in terms of credit spreads on existing and newly issued debt. Companies with fundamentally sound business models and little regulatory risk are still able to access the credit markets, albeit at a higher cost than earlier in the year. However, companies with any sort of material regulatory or business uncertainty (real or perceived) have been issuing debt at what would previously have been described as non-investment grade levels, if they are able to access the credit markets at all.

**ARIZONA CORPORATION COMMISSION STAFF'S FIRST SET OF DATA REQUESTS – October 4, 2002**
**TO ARIZONA PUBLIC SERVICE COMPANY**
**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**

EXHIBIT AB-10

STAFF 1-3 (MJR) Please identify whether PWEC currently has or in the past has had any plans to build additional plants. If so, please describe all such plans and their current status.

RESPONSE:

PWEC continually evaluates whether to construct or purchase additional plants. As the Commission knows, PWEC currently has a CEC for Redhawk Units 3 & 4 and continues to evaluate whether and, if so, where additional plants should be constructed.

Over the past few years, PWEC has pursued various opportunities relating to the construction or acquisition of plants. Specifically, over the past few years, PWEC has announced the following projects:

a) On April 23, 1999, PNW and Calpine announced the joint development of a nominally rated 500 MW gas-fired plant to be located at the West Phoenix Power Plant. No final agreement was reached between PNW and Calpine. West Phoenix CC5 is now wholly owned by PWEC.

b) On March 13, 2000, PWEC and Reliant announced plans to jointly construct 2,500 MW of new gas-fired generation in Arizona and Nevada. Approximately 1,000 MW was to come from Redhawk Units 1 & 2 and 1,500 MW would be constructed near Las Vegas and in Northern Arizona. No final agreement was reached between PWEC and Reliant. Redhawk Units 1 & 2 are now wholly owned by PWEC.

c) On April 27, 2000, PWEC announce the planned purchase of Southern California Edison's ownership interests in the Palo Verde Nuclear Generation Station and the Four Corners Power Plant. California passed legislation prohibiting the transfer of SCE's interests.

d) In late 2000, PWEC participated in the Nevada Power Company auction for power plants in Nevada. PWEC won the bid to purchase Nevada Power's Harry Allen facility. PWEC planned to operate the existing facility and to construct a new 500 MW gas-fired plant at the site. Nevada passed legislation prohibiting the transfer of Nevada Power's interests in generation. PWEC instead is constructing Silverhawk at a nearby site.

Although none of the above projects came to fruition as initially announced, PWEC has completed the construction of Redhawk Units 1 & 2, West Phoenix CC4 and the Saguaro CC expansion project. West Phoenix CC5 and Silverhawk are currently under construction.

April 26, 1999

ECTION: Vol. 4, No. 78

LENGTH: 249 words

HEADLINE: Calpine, APS plan 500-MW plant in Phoenix

BODY:

Pinnacle West Capital and Calpine announced late Friday a plan to develop a 500-MW, natural gas-fired, combined-cycle power plant in Phoenix for $220 million.

The facility would be located on the site of Arizona Public Service's (APS) West Phoenix Power Station. APS is a subsidiary of Pinnacle West.

The joint project is the second phase of a potential 750-MW expansion at West Phoenix. The first phase of the expansion includes a $60 million repowering of an existing unit to create a 130-MW combined-cycle unit. The remainder of the expansion involves repowering other existing units at the site. They will also install advanced pollution-control equipment to reduce air emissions from the existing units.

Construction on the new plant is scheduled to begin in mid-2000, with commercial operation of the 130-MW unit planned in mid-2001 and the 500-MW plant in late 2001.

Pinnacle West CEO Bill Post said the new capacity will help APS to meet growing demand and would also help the company to "pursue new opportunities in competitive generation markets."

But Pinnacle West said growth in electricity demand has increased by about 6% annually in Arizona, including nearly a 10% jump between 1997 and 1998. Peak demand for power in the Phoenix metropolitan area is expected to continue to increase due to both population growth and increased economic expansion, the company said.

Pinnacle West companies own or operate nearly 8,000 MW in Arizona and New Mexico. RH
URL: http://www.platts.com

LOAD-DATE: May 03, 1999

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T ARIZONA REPUBLIC

April 26, 1999, Monday

-ACC-NO: AR-PWR-PLANT

LENGTH: 341 words

HEADLINE: Pinnacle West Capital to Develop Phoenix Power Plant with Calpine Corp.

BYLINE: By Max Jarman

BODY:

Pinnacle West Capital Corp. has formed a joint venture with Calpine Corp. of San Jose, Calif., to develop a $ 220 million power plant near 43rd Avenue and Buckeye Road in Phoenix.

The state-of-the-art, natural gas-fire plant will generate enough electricity for 120,000 homes and prevent the possibility of Valley power shortages in the next few years.

Craig Nesbitt, a spokesman with Pinnacle West's Arizona Public Service Co. subsidiary, said the company does not have enough current generation or transmission capabilities to keep up with projected demand.

"We have no choice but to build more facilities," he said.

Nesbitt said the project is being developed by Pinnacle West instead of APS in anticipation of electricity deregulation rules that will require utilities to separate generation from their distribution business.

While Pinnacle West and Calpine say there are no additional projects planned beyond the initial partnerships, both acknowledge other ventures are possible.

Calpine is building a similar project on land leased from the Fort Mohave Indian Tribe, 28 miles southeast of Bullhead City.

The 500-megawatt Phoenix plant will be built on APS' 100-acre West Phoenix Power station. The project will add 200 Valley jobs during construction and about 25 full-time position after completion in late 2001. Construction is scheduled to start later this year. The new facility will be jointly-owned by Pinnacle West and Calpine.

Calpine's founder and chief executive officer Peter Cartwright said the partnership with Pinnacle West is a good fit in that Pinnacle West and APS have the site and connections in Phoenix and Calpine has the expertise in developing efficient, low-cost power plants. The 15-year-old company has 36 such facilities around the country and has 10 more under construction or in various stages of planning.

# PINNACLE WEST CAPITAL CORPORATION
# ANNUAL REPORT 2000

# TO OUR SHAREHOLDERS:

*Pinnacle West had a great year in 2000. We produced excellent results under conditions which tested our workforce, our knowledge of the western grid, our resiliency to market fluctuations and our ability to anticipate and act. We met these challenges and our shareholders were rewarded. Sighting on the future remains key. However, as this year's cover suggests, predictive tools have limitations, even those with wide-angle lenses. This is why we insist on preparing for a variety of outcomes.*

## REAL EARNINGS, REAL ASSETS, REAL GROWTH

In the year 2000, power supplies tightened in the West, and wholesale power prices soared. Natural gas also reached new levels of price and volatility. These conditions collapsed the recently created California energy market, and a new structure is slowly evolving. Anticipating the ultimate resolution to this situation is beyond mere planning tools and expertise.

While these events swirled around us, we increased earnings by 12 percent while lowering customer prices for the sixth time in seven years. Starting in 1994, APS has decreased electric prices a total of 11.4 percent. While others in the West are reacting to crises, we're preparing for the next round of competition, in both the market and regulatory arenas, to provide future value to our shareholders. That's a competitive advantage.

Last year, APS experienced strong customer growth of 3.7 percent, about three times the national average. We also increased the number of customers served per employee, as we did throughout the 1990s when we doubled that number.

Not only are we adding more customers, our customers are more satisfied. In 2000, our customer satisfaction rating rose significantly, and we expect to continue to improve in 2001.

Rapid customer growth and high prices on the wholesale power market didn't stop us from delivering reliable power – and we're working to make sure it never does. We've kept pace with growth and market volatility by planning for and building the distribution and transmission infrastructure needed to serve our customers.

On the generation side, we're meeting new demand growth through our unregulated subsidiary, Pinnacle West Energy. We broke ground on two major generation expansion projects and produced another year of outstanding performance from our fossil and nuclear units.

Increasingly efficient performance from our power plants, due to the employees who run them, helped us meet high demand from our customers, and allowed us to participate in the wholesale market.

Our cash flow is among the strongest in the industry – based on per share cash from operations – and allows us the flexibility to expand generation. Over the next five years, we will be financing a majority of our growth from internal sources and plan to maintain investment-grade credit ratings for our corporate-level securities.

Although the current power market is volatile and the regulatory environment is unsettled, we're confident of who we are, where we are, and where we're headed.

William J. Post, *Chairman*

## A FOCUS ON RISK MANAGEMENT

Last year's results prove we can achieve the agility demanded by our changing industry. That means emphasizing the importance of risk management for the entire corporate enterprise.

Our approach to risk management includes buying and selling power, but there's more to it. We limit our risks by emphasizing and strengthening our areas of expertise while pursuing growth opportunities that make sense.

At the holding company level, our power trading and marketing group is adeptly balancing the market risks between delivery and supply. Unlike many utilities, we have not had a "fuel adjustment clause" to manage fuel risk since 1988. We've turned this apparent negative into a positive by fine-tuning the risk management skills needed to thrive in a competitive marketplace.

Our subsidiaries have been doing business in the West for a long time. We know the area, we know the people, we know the challenges. As we said last year, there are places we won't go. Instead, we will use our foundation and our planning capability to capture the benefits of customer growth on all sides of our business.

## GROWING AND BUILDING

With APS, our regulated subsidiary, we will increasingly capture the benefits of customer growth with a regulatory Settlement Agreement that allows us to meet future customer needs while benefiting our shareholders.

We focus intensely on the total business, which means generation as much as delivery. As new units at our West Phoenix and Redhawk plants are energized and we build or buy additional generation, we expect Pinnacle West Energy to be a source of earnings growth for our company.

Pinnacle West Energy has received approvals to build and is already in various stages of construction for 2,800 megawatts of new gas-fired capacity. We remain committed to growing our generation business, and capturing the advantages of our geographic location. But there are limits to the price we'll pay for growth. We're striving to balance new capacity with anticipated load growth, while maintaining a solid capital structure.

We are moving forward with plans to transfer generation assets and employees from APS to Pinnacle West Energy. As authorized by the Settlement Agreement, we will transfer our existing generation operations to Pinnacle West Energy by the end of 2002.

APS Energy Services, our competitive sales subsidiary, responds to opportunities to provide energy services

## AT PINNACLE WEST, WE AIM TO STAND APART FROM OUR INDUSTRY PEERS. WE'VE DONE SO WITH RECORD CUSTOMER GROWTH, EARNINGS AND PRODUCTIVITY.

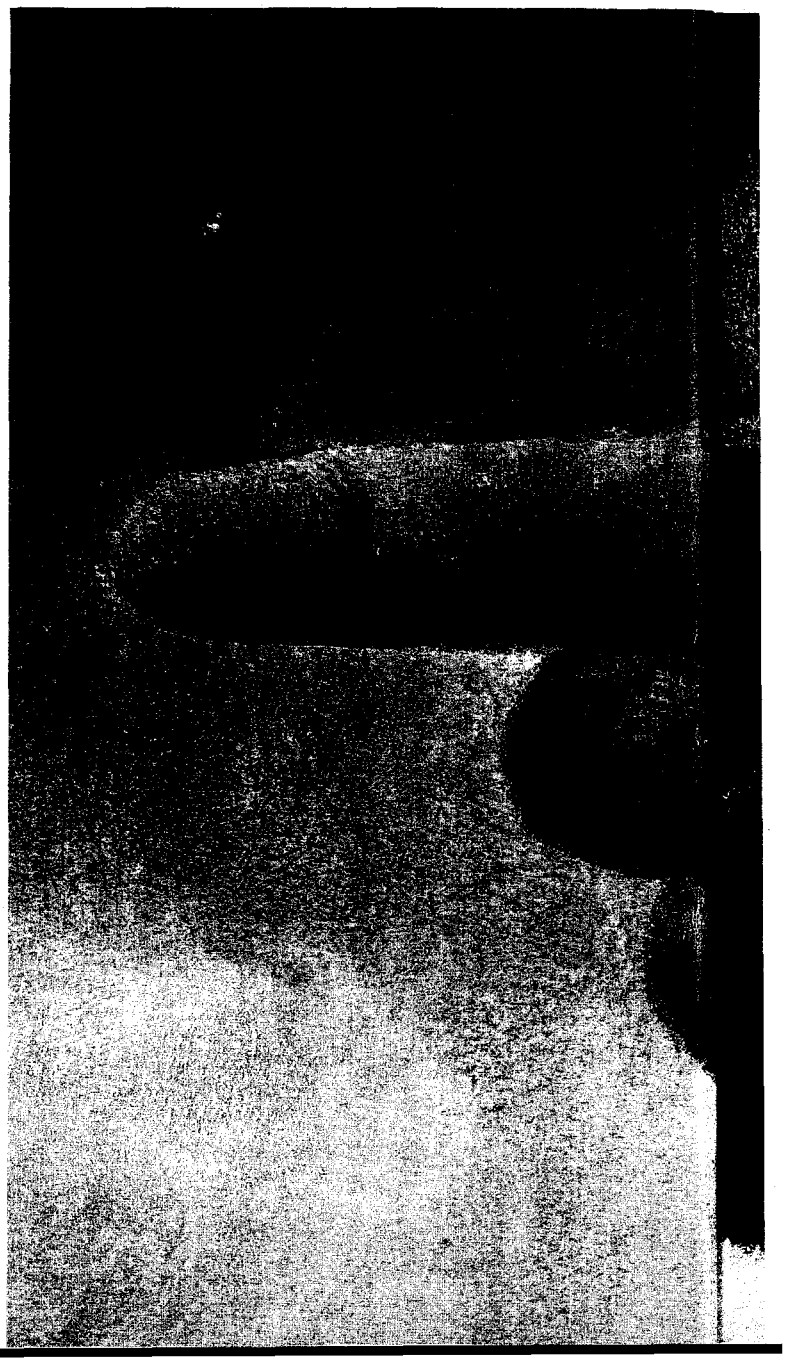
Unit 4 is scheduled to meet an in-service date of June 2001. The 530-megawatt West Phoenix Unit 5 is scheduled to begin operation in mid-2003.

The new Redhawk power plant, located near our Palo Verde Nuclear Generating Station and its region-serving transmission switchyard, is expected to consist of four 530-megawatt units. Construction began on Units 1 and 2 in December of 2000, and commercial operation is scheduled for mid-2002. We received the first combustion turbine for this project in the first quarter of 2001 and expect to energize the new switchyard near the end of the year.

Pinnacle West Energy is exploring the feasibility of developing an underground natural gas storage facility west of Phoenix. Test drilling to confirm geological studies is under way. Such a facility could provide protection from price spikes and supply interruptions for our new plants. This facility could also provide a business opportunity in supplying gas storage capacity to other companies.

By summer 2001, we will add more than 500 megawatts of generating capacity from our new West Phoenix unit as well as some leased portable units and the reactivation of existing units. A portion of this added capacity has been several years in the planning, but some is being added as a precaution against unforeseen increases in demand. As we expand our gas-fired capacity, we will achieve a desirable balance among the three major fuels – nuclear, coal and natural gas.

By completing new units at West Phoenix and Redhawk and building or buying additional generation, we expect Pinnacle West Energy to be a major earnings growth engine.



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APS-13
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PANDA.I.Q. 42

# Pinnacle West Capital Corporation

## Analyst Presentations
## Boston and New York
## April 11-12, 2000

This presentation contains forward-looking statements that involve risks and uncertainties, which include, but are not limited to, the ongoing restructuring of the electric industry; the outcome of the proceedings relating to the restructuring; regional economic and market conditions, which could affect customer growth and the cost of power supplies; the cost of debt and equity capital; weather variations affecting customer usage; and the strength of the stock market (particularly the technology sector) and the real estate market. These factors and the other matters discussed may cause future results to differ materially from historical results, or from results or outcomes currently expected or sought by the company.

## Positioning

### Today (2000-2003)

- Acquire fossil assets operated for others
- Increase Palo Verde ownership to a majority
- Build new generation sites and alliances
- Drive regulated costs down ahead of price reductions
- Maintain financial strength
- Align expansion with regulated load
- Expand risk-driven trading function
- Emphasize regulatory change function
- Expand technology and related holdings
- Improve asset turn rate
- Improve performance, cost and price

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# Energy Delivery & Sales

Jack Davis
Analyst Conference
October 26, 2000

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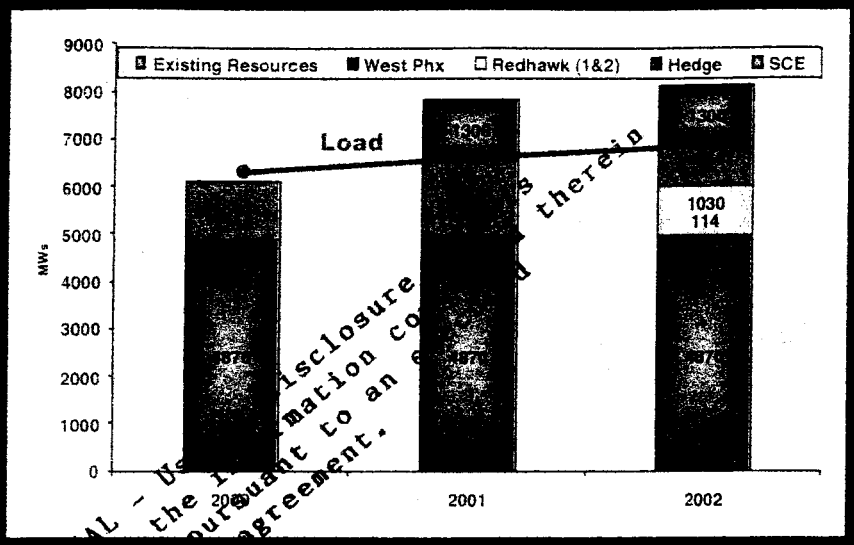
# Enterprise Electric Hedge Strategy

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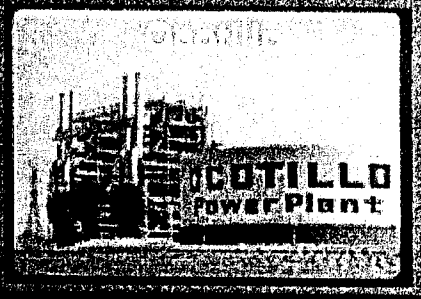
PINNACLE WEST ENERGY

# Pinnacle West Energy Corporation

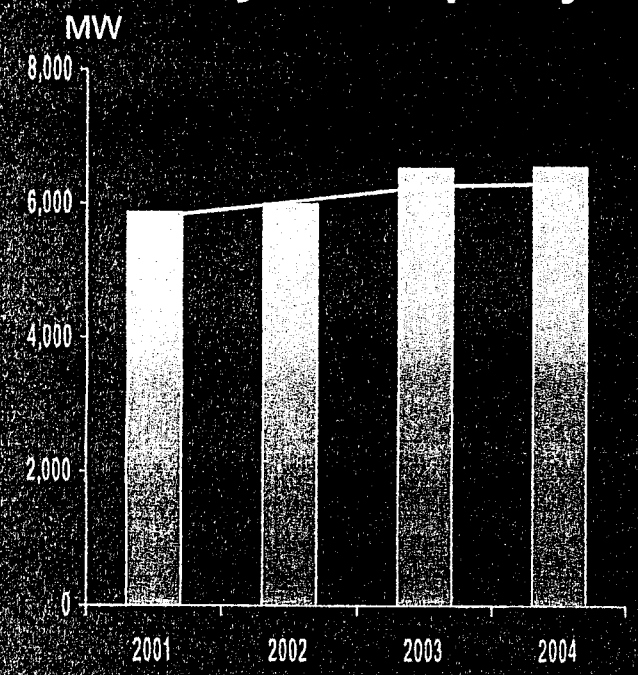
*One of the Largest Generation Companies in the West*

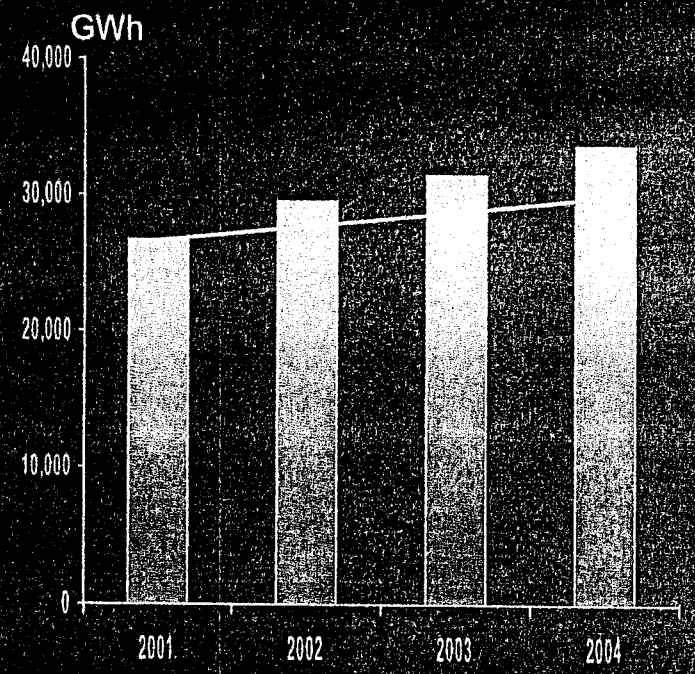



**Rating Agency Presentation**
**February 2001**

Moody's, S&P, & Fitch

# PWEC Uniquely Positioned With Adequate Capacity and Surplus Energy




APS/PWEC Generation* — APS Load

- Adequate capacity designed to meet APS' growing needs
- Power Marketing sales of surplus generation to other markets enhance profit margins during Q1, Q2, Q4

*Includes spot and long-term contracts

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# Pinnacle West Capital Corporation

# dif•fer•en•ti•ate

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**Analyst Presentations**
**Boston and New York**
**April 23 - 24, 2002**

# Pinnacle West
# Generation Expansion Strategy

- Disciplined
- Flexible to meet load growth

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# Pinnacle West
# Growing Generation Capability

| Commercial Operation | New Facilities | MWs |
|---|---|---|
| 2001 | West Phoenix 4 | 120 |
| 2002 | Redhawk 1 & 2 | 1,060 |
| 2002 | Saguaro CT 3 | 80 |
| 2003 | West Phoenix 5 | 530 |
| 2004 | Silverhawk | 570 |
| 2006/2007 | Redhawk 3 and 4 | 1,060 |

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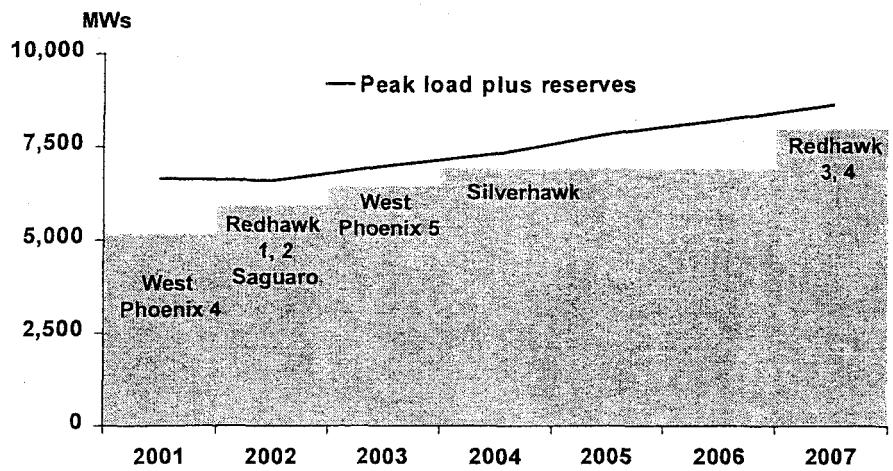
# Pinnacle West Generation Resources Growing in Pace with Demand

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# Summer Loads & Resources (MW) - COMPETITIVE

| | | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **APS SYSTEM SALES** | | | | | | | | | | | | | | | | | | | |
| 1 | FIRM | 5091 | 5287 | 5220 | 5407 | 5573 | 5787 | 5971 | 6168 | 6362 | 6554 | 6754 | 6957 | 7161 | 7368 | 7574 | 7781 | 7996 | 8215 | 8431 |
| 2 | INTERRUPTIBLE | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 |
| 3 | TOTAL | 5291 | 5487 | 5420 | 5607 | 5773 | 5987 | 6171 | 6368 | 6562 | 6754 | 6954 | 7157 | 7361 | 7568 | 7774 | 7981 | 8196 | 8415 | 8631 |
| 4 | ANNUAL LOAD GROWTH % | 3.7 | 3.7 | -1.2 | 3.5 | 3.0 | 3.7 | [illegible] | 3.2 | 3.0 | 2.9 | 3.0 | 2.9 | 2.9 | 2.8 | 2.7 | 2.7 | 2.7 | 2.7 | 2.6 |
| | **GENERATION RESOURCES** | | | | | | | | | | | | | | | | | | | |
| 5 | EXISTING GENERATION | 3987 | 3987 | 3987 | 3987 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 | 3995 |
| 6 | CUC GENERATION (NOGALES) (A) | 42 | 42 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 7 | W. PHOENIX RECOMMISSION | 96 | 96 | 96 | 96 | 96 | 96 | 96 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 8 | W. PHOENIX REPOWER | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 195 | 195 | 195 | 195 | 195 | 195 | 195 | 195 | 195 | 195 | 195 | 195 |
| 9 | W. PHOENIX NEW CC 4 | 0 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 | 118 |
| 10 | SEASONAL VARIATION | (77) | (77) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) | (75) |
| 11 | CAPACITY ON MAINTENANCE | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 12 | TOTAL | 4049 | 4167 | 4126 | 4126 | 4134 | 4134 | 4134 | 4233 | 4233 | 4233 | 4233 | 4233 | 4233 | 4233 | 4233 | 4233 | 4233 | 4233 | 4233 |
| | **PURCHASED POWER RESOURCES** | | | | | | | | | | | | | | | | | | | |
| 13 | SRP - TERRITORIAL (B) | 267 | 274 | 281 | 288 | 295 | 302 | 310 | 318 | 326 | 334 | 342 | 351 | 360 | 368 | 378 | 387 | 397 | 407 | 417 |
| 14 | SRP - CONTINGENT | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 | 62 |
| 15 | PACIFICORP CONTRACTS (B) | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 | 480 |
| 16 | SHORT-TERM PURCHASES | 845 | 603 | 50 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 17 | TOTAL PURCHASES | 1654 | 1419 | 873 | 830 | 837 | 844 | 852 | 860 | 868 | 876 | 884 | 893 | 902 | 910 | 920 | 929 | 939 | 949 | 959 |
| | **SALES COMMITMENTS** | | | | | | | | | | | | | | | | | | | |
| 18 | SALE-BACK | 0 | 273 | 273 | 273 | 273 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 19 | MARKET SALE | | 0 | 0 | 399 | 1325 | 2214 | 2673 | 2708 | 2522 | 2561 | 2592 | 2622 | 2650 | 2674 | 2701 | 2726 | 2521 | 2313 | 2106 |
| 20 | TOTAL SALES | 0 | 273 | 273 | 672 | 1598 | 2214 | 2673 | 2708 | 2522 | 2561 | 2592 | 2622 | 2650 | 2674 | 2701 | 2726 | 2521 | 2313 | 2106 |
| 21 | DISTRIBUTED GENERATION | 7 | 13 | 25 | 29 | 32 | 34 | 35 | 36 | 36 | 36 | 36 | 36 | 36 | 36 | 36 | 36 | 36 | 36 | 36 |
| 22 | GROWTH PLAN | | | | | | | | | | | | | | | | | | | |
| 23 | Increased PV Share | | 367 | 367 | 367 | 967 | 967 | 967 | 967 | 967 | 967 | 967 | 967 | 967 | 967 | 967 | 967 | 967 | 967 | 967 |
| 24 | Increased FOUR CORNER 4-5 SHARE | | 104 | 104 | 104 | 208 | 208 | 918 | 918 | 918 | 918 | 918 | 918 | 918 | 918 | 918 | 918 | 918 | 918 | 918 |
| 25 | Increased NAVAJO SHARE | | 169 | 169 | 169 | 169 | 589 | 589 | 589 | 589 | 589 | 589 | 589 | 589 | 589 | 589 | 589 | 589 | 589 | 589 |
| 26 | W. PHOENIX NEW CC 5 | 0 | 0 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 | 250 |
| 27 | HEDGEHOG NEW CC | 0 | 0 | 0 | 500 | 1000 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 | 1500 |
| 28 | OTHER PROJECTS | 0 | 0 | 250 | 250 | 250 | 250 | 250 | 500 | 500 | 750 | 1000 | 1250 | 1500 | 1750 | 2000 | 2250 | 2250 | 2250 | 2250 |
| 29 | TOTAL | 0 | 640 | 1140 | 1640 | 2844 | 3764 | 4474 | 4724 | 4724 | 4974 | 5224 | 5474 | 5724 | 5974 | 6224 | 6474 | 6474 | 6474 | 6474 |
| 30 | TOTAL RESOURCES [10+15+21+25] | 5710 | 6239 | 6164 | 6625 | 7847 | 8776 | 9495 | 9853 | 9861 | 10119 | 10377 | 10636 | 10895 | 11153 | 11413 | 11672 | 11682 | 11692 | 11702 |
| 31 | PLANNED RESERVES [30-1-18] | 618 | 679 | 672 | 547 | 677 | 775 | 852 | 978 | 978 | 1005 | 1031 | 1058 | 1084 | 1112 | 1139 | 1165 | 1165 | 1165 | 1165 |
| 32 | PLANNED RESERVES % | 14% | 14% | 14% | 10% | 11% | 11% | 11% | 12% | 12% | 12% | 12% | 12% | 12% | 12% | 12% | 12% | 12% | 12% | 12% |
| 33 | APS Load Factor, % | 53.1 | 53.1 | 54.8 | 54.7 | 54.6 | 54.5 | 54.2 | 54.1 | 53.9 | 53.9 | 53.9 | 53.8 | 53.5 | 53.6 | 53.5 | 53.4 | 53.1 | 53.2 | 53.1 |
| 34 | GBU Capacity Factor, % | 67.2 | 72.2 | 72.0 | 72.3 | 76.4 | 76.2 | 76.7 | 76.7 | 76.5 | 77.1 | | | | | | | | | |

Notes:

(A) Owned by another utility, but available to meet APS system load.

(B) The reserves for this capacity are provided by the seller.

(C) Small cogeneration, turbine and renewable projects also owned by others.

Updated June 11, 1999

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EXHIBIT
APS-18
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Special
Open Meeting of the
Arizona Corporation Commission
Energy Workshop

February 16, 2001
Arizona Public Service Company
Cary B. Deise
Director, Transmission Operations and Planning

## Overview

- Reliability
- Service Territory
- Load Forecast
- Resources
- Fuel Supply Plan
- Transmission
- Conclusion

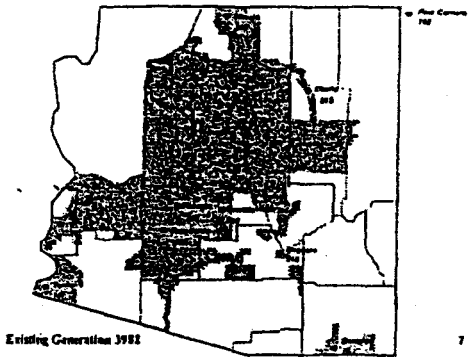
2

## Reliability

- To meet customers electric energy requirements on time.
- Factors impacting reliability
  - Customer Requirements
  - Transmission, Generation and Distribution availability
  - Weather
  - Neighboring systems

3

## APS Existing Generation
(Nominal ratings in MW)



Existing Generation 3982

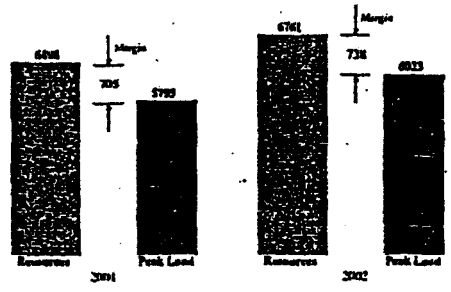
7

## Resources

| | 2001 | 2002 |
|---|---|---|
| • Existing Generation | 3982 | 4197 |
| Renewable | 9 | 13 |
| • Additions | | |
| Upgrade of existing CC&CT | 107 | - |
| Reactivate WPhx Steam 4&6 | 96 | - |
| WPhx CC 4 | 114 | - |
| Temporary WPhx CT's - 5 units | 99 | (99) |
| Temporary Saguaro CT's - 5 units | 99 | (99) |
| Redhawk CC 1&2 | - | 988 |
| Subtotal | 515 | 790 |
| • Long-term Contracts | | |
| Pacificorp Exchange | 480 | 480 |
| SRP | 336 | 343 |
| Subtotal | 816 | 823 |
| • Short-term Contracts | 1176 | 638 |
| • Total Resources | 6498 | 6761 |

8

## APS Load and Resources

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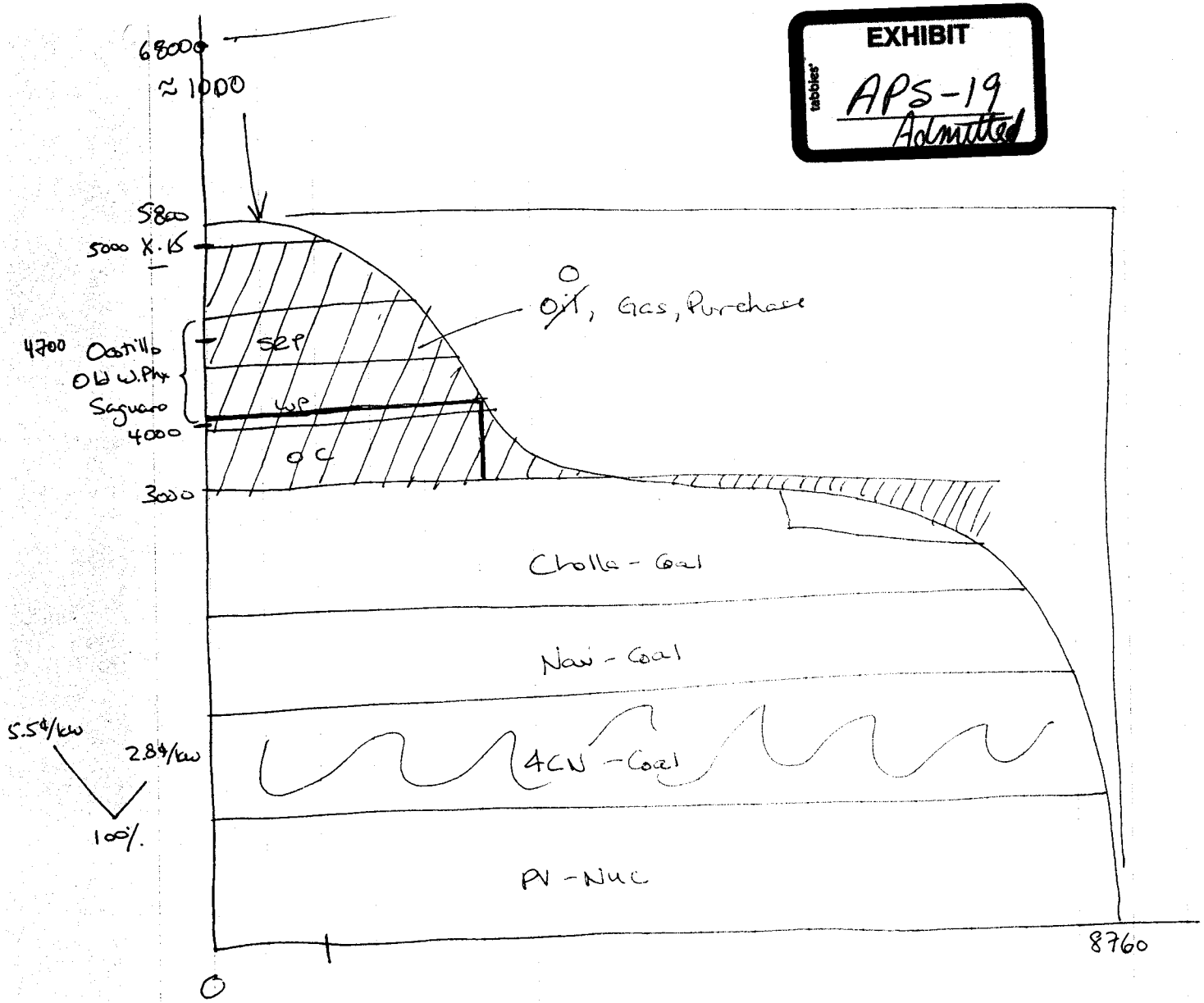


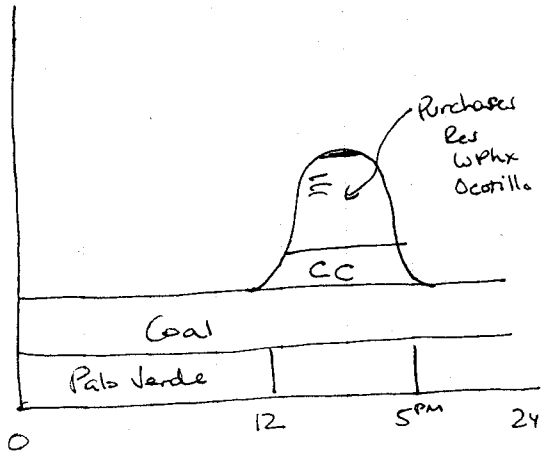

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APS-20
Admitted

## *2002 APS/PWEC Resources and Sales* (1)
## *Summary*

| | MWH | |
|---|---|---|
| Generation | 25,179,796 | |
| Purchases | 2,800,559 | 11.1% |
| Total Resources | 27,980,355 | |
| Sales to Others (2) | (2,658,035) | 9.5% |
| APS Load (3) | 25,322,320 | |

(1) All data is preliminary (prior to year-end close).

(2) 11.1% of APS' load requirements were purchased and 9.5% of total resources were sold to others at the following delivery points: Palo Verde, Mead, Four Corners, Westwing, Pinnacle Peak, CAISO, Lolo, Navajo, Borah Brady, Glen Canyon, La Grande, Saguaro, Parker Davis, Mid-Columbia, Cholla, Abitibi and Wrangly. Due to the multiple delivery points both within and outside Arizona, it is not possible to directly determine ultimately where the actual consumption occurred (e.g. delivery may occur at Palo Verde, but actual consumption may occur in California).

(3) Retail and wholesale cost-of-service customers only.

# *2002 Generation Information*

| Generator Name | Generation (MWH) |
|---|---|
| Cholla ST1 | 815,970 |
| Cholla ST2 | 1,599,696 |
| Cholla ST3 | 1,788,577 |
| Douglas CT1 | 1,085 |
| Four Corners ST1 (1) | 1,182,105 |
| Four Corners ST2 (1) | 1,323,947 |
| Four Corners ST3 (1) | 1,718,945 |
| Four Corners ST4 (1) | 873,742 |
| Four Corners ST5 (1) | 583,491 |
| Navajo ST1 | 737,774 |
| Navajo ST2 | 719,531 |
| Navajo ST3 | 749,402 |
| Ocotillo CT1 | 16,196 |
| Ocotillo CT2 | 15,851 |
| Ocotillo ST1 | 163,113 |
| Ocotillo ST2 | 100,223 |
| Palo Verde ST1 | 2,828,517 |
| Palo Verde ST2 | 2,931,224 |
| Palo Verde ST3 | 3,252,426 |
| Red Hawk 1 | 1,122,703 |
| Red Hawk 2 | 942,568 |
| Saguaro CT1 | 14,033 |
| Saguaro CT2 | 9,078 |
| Saguaro CT3 | 48,920 |
| Saguaro ST1 | 90,075 |
| Saguaro ST2 | 103,174 |
| West Phoenix CC1 | 253,974 |
| West Phoenix CC2 | 266,089 |
| West Phoenix CC3 | 346,135 |
| West Phoenix CC4 | 464,753 |
| West Phoenix CT1 | 12,744 |
| West Phoenix CT2 | 18,487 |
| West Phoenix ST4 | 0 |
| West Phoenix ST6 | 0 |
| Yucca CT1 | 6,603 |
| Yucca CT2 | 7,696 |
| Yucca CT3 | 69,397 |
| Yucca CT4 | 1,552 |
| Total | 25,179,796 (1) |

(1) 22.6% of APS generation comes from outside Arizona (5,682,230 MWH from Four Corners).

# *2002 Energy Puchased*

| Company | MWH |
|---|---|
| Abitibi Consolidated Sales Corporation | 733 |
| Allegheny Energy Supply Company, LLC | 3,744 |
| American Electric Power Service Corp. | 22,757 |
| Aquila Merchant Services, Inc. | 9,581 |
| Arizona Electric Power Coop. | 1,147 |
| Avista Corporation | 92 |
| BP Energy Company | 3,596 |
| Burbank, City of | 195 |
| Calif. Dept. of Water Resources F.B.O. CERS | 15,285 |
| California Independent System Operator | 2,317 |
| Calpine Energy Services, LP | 12,249 |
| Cargill Power Markets, LLC | 3,626 |
| Colorado River Commission | 0 |
| Colorado River Storage Project (WAPA) | 583 |
| Conoco, Inc. | 373 |
| Constellation Power Source, Inc. | 1,174 |
| Coral Power, L.L.C. | 7,260 |
| Duke Energy Trading & Marketing | 15,541 |
| Dynegy Power Marketing, Inc. | 5,395 |
| Edison Mission Marketing & Trading, Inc. | 960 |
| El Paso Electric Company | 5,439 |
| El Paso Merchant Energy, L.P. | 19,779 |
| Entergy-Koch Trading, LP | 225 |
| Exelon Generation Company, LLC | 1,999 |
| Idacorp Energy L.P. | 5,807 |
| Imperial Irrigation District | 148 |
| Los Angeles Department of Water & Power | 15,197 |
| MEICO, INC. | 400 |
| Metropolitan Water District | 1,112 |
| Mirant Americas Energy Marketing, LP | 16,224 |
| Miscellaneous Control Area | 615,176 |
| Morgan Stanley Capital Group, Inc. | 7,859 |
| M-S-R Public Power Agency | 437 |
| Nevada Power Co. | 22,916 |
| Northwestern Energy LLC | 92 |
| PacifiCorp | 120,097 |
| PacifiCorp Exchange | 414,254 |
| PG&E Energy Trading-Power, L.P. | 4,304 |
| Pinnacle West Capital Corp. | 139,280 |
| Portland General Electric Co. | 2,200 |
| Powerex | 16,505 |
| PPL Energy Plus, LLC | 48,674 |
| PPL Montana, L.L.C. | 600 |
| PPM Energy, Inc. | 664 |
| Public Service Company of Colorado | 11,112 |
| Public Service Company of New Mexico | 20,122 |

| | |
|---|---|
| Redding, City of | 227 |
| Reliant Energy Services, Inc. | 2,918 |
| Salt River Project | 24,013 |
| Salt River Project T&C | 1,100,000 |
| San Diego Gas & Electric Co. | 24,362 |
| Seattle City Light | 184 |
| Sempra Energy Trading Corp. | 8,591 |
| Southern California Edison | 1,215 |
| TransAlta Energy Marketing, U.S., Inc. | 10,509 |
| Tri-State Generation and Transmission Association | 60 |
| Tucson Electric Power Co. | 2,871 |
| TXU Energy Trading Company LP | 4,443 |
| WAPA, Desert Southwest Region | 50 |
| Williams Energy Marketing and Trading Co. | 23,884 |
| Total | 2,800,559 |

# *2002 Energy Sold*

| Company | MWH |
|---|---|
| Abitibi Consolidated Sales Corporation | 360 |
| Allegheny Energy Supply Company, LLC | 12,840 |
| American Electric Power Service Corp. | 159,111 |
| Aquila Merchant Services, Inc. | 25,601 |
| Arizona Electric Power Coop. | 6,039 |
| Avista Corporation | 9,150 |
| BP Energy Company | 30,597 |
| Burbank, City of | 1,076 |
| Calif. Dept. of Water Resources F.B.O. CERS | 84,090 |
| California Independent System Operator | 100 |
| Calpine Energy Services, LP | 12,077 |
| Cargill Power Markets, LLC | 1,335 |
| City of Glendale Water & Power | 35 |
| Colorado River Commission | 2,025 |
| Colorado River Storage Project (WAPA) | 69,522 |
| Conoco, Inc. | 1,325 |
| Constellation Power Source, Inc. | 11,744 |
| Coral Power, L.L.C. | 67,273 |
| Duke Energy Trading & Marketing | 66,045 |
| Dynegy Power Marketing, Inc. | 36,027 |
| El Paso Electric Company | 8,146 |
| El Paso Merchant Energy, L.P. | 41,556 |
| Entergy-Koch Trading, LP | 12,486 |
| Idacorp Energy L.P. | 16,682 |
| Idaho Power Company | 44,929 |
| Imperial Irrigation District | 1,135 |
| Los Alamos County | 35,221 |
| Los Angeles Department of Water & Power | 196,509 |
| MEICO, INC. | 5,883 |
| Mirant Americas Energy Marketing, LP | 120,988 |
| Miscellaneous Control Area | 43,963 |
| Morgan Stanley Capital Group, Inc. | 67,471 |
| Nevada Power Co. | 13,685 |
| Northwestern Energy LLC | 18,945 |
| PAC Supplemental Coal | 90,032 |
| PAC Supplemental Other | 15,075 |
| PacifiCorp | 129,171 |
| Pacificorp Exchange | 391,510 |
| PacifiCorp Power Marketing, Inc. | 350 |
| PG&E Energy Trading-Power, L.P. | 11,580 |
| Pinnacle West Capital Corp. | 366,810 |
| Portland General Electric Co. | 8,750 |
| Powerex | 19,291 |
| PPL Energy Plus, LLC | 1,891 |

| | |
|---|---|
| PPL Montana, L.L.C. | 1,540 |
| Public Service Company of Colorado | 44,977 |
| Public Service Company of New Mexico | 39,861 |
| Reliant Energy Services, Inc. | 10,511 |
| Salt River Project | 16,953 |
| San Diego Gas & Electric Co. | 2,243 |
| Seattle City Light | 19,593 |
| Sempra Energy Trading Corp. | 125,337 |
| Sierra Pacific Power Co. | 2,440 |
| Silicon Valley Power; City of Santa Clara | 16,686 |
| Southwestern Public Service | 750 |
| TECO Energy Source, Inc. | 1,900 |
| Tohono O Odham Utility Authority | 9 |
| Tractebel Energy Marketing, Inc. | 9,989 |
| TransAlta Energy Marketing, U.S., Inc. | 34,698 |
| Tri-State Generation and Transmission Association | 3,237 |
| Tucson Electric Power Co. | 14,010 |
| TXU Energy Trading Company LP | 8,612 |
| Vernon, City of | 200 |
| WAPA, Desert Southwest Region | 6,720 |
| Wickenburg, City Of | 1,464 |
| Williams Energy Marketing and Trading Co. | 37,874 |
| Total | 2,658,035 (1) |

(1) APS cannot determine whether these sales volumes were consumed within or outside Arizona. However, the purchasing entities can be categorized as follows:

| | MWH | |
|---|---|---|
| In-state Entities | 456,328 | 17.2% |
| PacifiCorp Exchange | 391,510 | 14.7% |
| Out-of-state Entities | 1,810,197 | 68.1% |
| | 2,658,035 | |

EXHIBIT
APS-21
Admitted

# Year 2002 Water use at Pinnacle West/APS Power Plants

All Values in Acre-Feet

| | Total Plant Water Use | Water Use By Source | | |
|---|---|---|---|---|
| | | Gound Water | Surface Water | Treated Effluent |
| **Coal Plants** | | | | |
| **Cholla (a)** | **15,400** | 15,400 | 0 | 0 |
| **Four Corners (c)** | **21,085 (b)** | 0 | 21,085 (b) | 0 |
| **Navajo (d)** | **30,000** | 0 | 30,000 | 0 |
| **Oil and Gas Plants** | | | | |
| **Ocotillo** | **1,050** | 1,050 | 0 | 0 |
| **Redhawk** | **2,941** | 83 | 0 | 2,858 |
| **Saguaro** | **770** | 770 | 0 | 0 |
| **West Phoenix** | **2,325** | 2,325 | 0 | 0 |
| **Yucca (e)** | **925** | 925 | 0 | 0 |
| **Nuclear Plants** | | | | |
| **PVNGS (f)** | **71,706** | 1,979 | 0 | 69,727 |

Note (a): APS Owns 61.8% of Cholla Power Plant

Note (b): Water Use for 12 months, December 2001 through November 2002. Water Source San Jaun river.

Note (c): APS Owns 38.3% of Four Corners Power Plant

Note (d): Plant Operated by SRP. Water Source is Lake Powell. APS Owns 14% of Navajo Power Plant

Note (e): A majority of the water use is for the Steam Plant owned by IID.
APS owns 4 Combustion Turbines at Yucca. They use very little water.
Water source is groundwater that is treated as Colorado River Water.

Note (f): APS Owns 29.1% of PVNGS Power Plant

**EXHIBITS NOS.**

**P-23 and**

**APS 22 through 25**

**SUBJECT TO A**

**CONFIDENTIALITY**

**AGREEMENT.**

**BOUND UNDER**

**SEPARATE COVER.**

# AUIA

# 1 & 2

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

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

EXHIBIT
AUIA-1
Admitted

| | |
|---|---|
| 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 | DOCKET NO. E-01345A-02-0707 |

## NOTICE OF FILING

Pursuant to the Procedural Order dated October 9, 2002, the Arizona Utility Investors Association hereby provides notice of filing the direct testimony of Walter W. Meek in the above captioned proceeding.

Respectfully submitted, this 13th day of December, 2002.

Walter W. Meek

Walter W. Meek, President

CERTIFICATE OF SERVICE

An original and ten copies
of the referenced testimony
were filed this 13th day of
December, 2002, with:

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

Copies of the referenced testimony
were delivered this 13th day of
December, 2002, to:

Hercules Dellas, Esq., Commissioner Wing
Kevin Barlay, Esq., Commissioner Wing
Paul Walker, Esq., Commissioner Wing
Christopher Kempley, Esq., Legal Division
Lyn Farmer, Esq., Hearing Division
Ernest Johnson, Esq., Utilities Division
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

A copy of the referenced testimony mailed
this 13th day of December, 2002, to:

Thomas L. Mumaw, Esq.
Pinnacle West Capital Corporation
P.O. Box 52132
Phoenix, AZ 85072-2132

All Parties of Record

Walter W. Meek

DIRECT TESTIMONY

OF

WALTER W. MEEK

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite 210, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the president of the Arizona Utility Investors Association ("AUIA" or "Association"), a non-profit organization formed to represent the interests of shareholders and bondholders who are invested in utility companies that are based in or do business in the state of Arizona.

Q. ARE SOME AUIA MEMBERS SHAREHOLDERS OF PINNACLE WEST CAPITAL CORPORATION?

A. Yes. AUIA has approximately 6,000 members and a substantial percentage are common shareholders of Pinnacle West Capital Corporation ("PWCC"), the corporate parent of Arizona Public Service Company ("APS").

Q. WHAT IS YOUR BACKGROUND IN REPRESENTING SHAREHOLDER CONCERNS AND INTERESTS?

A. I have been president of AUIA for more than eight years. Prior to that, my consulting firm managed the affairs of the Pinnacle West Shareholders Association for 13 years. During this time we have represented shareholders in numerous rate cases and other regulatory matters and have published many position papers, newsletters and other documents in support of shareholder interests.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I am here to represent the views of the equity owners of PWCC regarding APS's request for authority to extend its credit to assure permanent financing for the Redhawk and West Phoenix power plants built by Pinnacle West Energy Corporation (PWEC).

Q. HOW WOULD THIS OCCUR?

A. As I understand it, APS wants the flexibility to loan up to $500 million or provide a corporate guarantee to PWCC or PWEC in support of a permanent financing plan to replace a majority of the bridge financing Pinnacle West currently has in place.

Q. WHAT IS AUIA'S POSITION?

A. We urge the Commission to grant APS the authority it seeks. We are convinced that this action would be in the public interest in safeguarding the financial integrity of APS and its parent. The alternatives to this course of action would be damaging to the entire Pinnacle West group of companies and to APS's customers.

Q. DO THESE POWER PLANTS SERVE APS CUSTOMERS?

A. Yes, they do.

Q. ARE THEY OWNED AND OPERATED BY APS?

A. No. They are owned and operated by PWEC, a Pinnacle West subsidiary.

Q. ARE THESE PLANTS SUBJECT TO COST-OF-SERVICE REGULATION BY THE CORPORATION COMMISSION?

A. No, they are not.

Q. WHY SHOULD THE COMMISSION BE CONCERNED ABOUT HOW THEY ARE FINANCED?

A. As the testimony of company witness Barbara Gomez indicates, Pinnacle West is on the brink of serious financial difficulties due to recent regulatory decisions affecting those power plants.

In our opinion, if Pinnacle West is punished in the financial markets, the impact will spill over onto APS and affect its ability to raise capital at a reasonable cost. Clearly, that could affect the cost and quality of customer service.

Q. IS THE COMMISSION AT FAULT FOR THIS SITUATION?

A. Blame should not be the issue here. However, we can't ignore the sequence of events that led to this dilemma.

Q. WHAT WERE THOSE EVENTS?

A. I don't want to belabor history, but the short version is this:

When the Commission adopted the electric competition rules in 1999, they included a directive to the utilities to divest all of their generation assets to one or more affiliated companies by the end of 2002. PWEC was formed for that purpose, to be the repository for APS's divested generation portfolio and long term supply contracts.

However, the Commission also made the utilities the providers of last resort, with the responsibility of providing their customers with reliable energy at an acceptable cost, regardless of divestiture.

When APS's forecasts showed the need for increased resources, the company concluded it was more prudent to build new generation, both inside and outside the Phoenix load pocket, than to rely entirely on wholesale purchases.

In anticipation of divestiture, Pinnacle West built and financed the plants within PWEC rather than in APS. In addition, the APS code of conduct, which was required by the electric competition rules, forbade the utility from engaging in competitive activity, which clearly applies to new generation.

PWEC had no appreciable assets, but an investment grade interim financing program was negotiated utilizing Pinnacle West's credit rating. Permanent financing at investment grade level was dependent on the transfer of APS's generating portfolio to PWEC.

Last Sept. 10, in Decision No. 65154, the Commission reversed course on divestiture, requiring the utilities to continue serving their customers with the generation that they own. That left the PWEC power plants in limbo, owned by an affiliate without permanent financing and with no access to credit.

Q. WAS IT A PRUDENT DECISION TO BUILD THESE FACILITIES?

A. Absolutely. In June 2000, when construction began on combined cycle Unit 4 at West Phoenix, the western electricity markets were beginning to come apart at the seams. Given the choice, a prudent utility manager would have preferred to own the sources of his incremental needs going forward than to rely on the wholesale market.

Q. WHAT IS THE MAGNITUDE OF PINNACLE WEST'S FINANCIAL EXPOSURE?

A. According to Ms. Gomez, Pinnacle West will be on the hook for about $765 million of PWEC investment by the middle of next year. At that time, the majority of the interim loans also will start coming due.

Q. WHAT PREVENTS THE COMPANIES FROM REFINANCING AT THE HOLDING COMPANY LEVEL?

A. It appears that without APS's participation, Pinnacle West simply doesn't have the asset base to support that much debt and PWEC reportedly has no access to credit at all. At a minimum, if PWCC could sustain this debt, it would take a serious and probably unacceptable hit to its financing costs and APS, as the chief underlying source of cash resources, would also be penalized in the financial markets.

Q. WHAT IF APS'S REQUEST IS DENIED?

A. The APS proposal is a reasonable attempt to rectify a very messy situation. The rating agencies have sent clear signals that more credit downgrades are in store for Pinnacle West and APS if the financing impasse isn't resolved in an acceptable manner. However, the consequences could go further than that.

Q. WHAT ARE THE OTHER CONSEQUENCES?

A. If APS's credit can't be utilized, we think it is not inconceivable that a bankruptcy and/or a forced sale of some or all of the PWEC assets could occur. Of course, any sale in the near future would be into a market that is already glutted with the bad construction decisions of merchant generators.

Q. WHAT WOULD BE THE IMPACT ON APS?

A. That is hard to predict, but it wouldn't be positive. These days, it is increasingly difficult to insulate an affiliate from the fortunes of its holding company and vice versa and it is unrealistic to expect that APS would be immune from a financial meltdown at Pinnacle West.

Q. WHAT ARE THE RISKS OF THE FINANCING PROPOSAL TO APS AND ITS CUSTOMERS?

A. There are no apparent risks. Ms. Gomez asserts that APS has plenty of credit headroom to handle a loan or guarantee to its affiliates without risk to its own credit and we have no reason to doubt her evaluation. Also, the plan would shield utility customers from any financing costs incurred by APS.

Q. WHAT IF A DEFAULT OCCURRED?

A. It could depend on the precise terms of the credit plan in place, but it's conceivable that APS could become the owner of a few generating units that have not been deemed to be used and useful. It wouldn't be the first time, as any veteran of the Palo Verde rate basing can attest. It would certainly be preferable to the consequences I discussed previously.

Q WHAT WOULD APS DO WITH THE PWEC PLANTS?

A. Again, that's hard to predict. It would depend on conditions at the time. Obviously, APS could seek permission to include them in its regulated rate base. If a default were far enough down the road, divestiture might be back in play. We don't discount entirely the possibility that Pinnacle West

might want to dispose of some of the PWEC units someday, but ideally, not until the market has absorbed some excess capacity.

Q. HOW COULD APS OWN AND OPERATE COMPETITIVE GENERATION IN A WHOLESALE BIDDING ENVIRONMENT?

A. It's doubtful that APS would attempt that. They could assign the PWEC units to another affiliate, which could bid their output, either at arm's length or in a blind bidding process like that proposed by company witness Thomas Carlson in the Track B proceeding.

Q. CAN PINNACLE WEST ISSUE STOCK TO PAY OFF THE PWEC DEBT?

A. It probably can, but that would be a poor decision if there were any other viable options.

Q. WHY WOULD THAT BE A BAD STRATEGY?

A. There are several reasons. First, it is probably the most costly option. Common equity is the most expensive component of a utility's capital structure and has a direct impact on revenue requirements from ratepayers.

Second, the price of Pinnacle West's common stock has been hovering at or below book value, 40 percent off of its 52-week high. It is not a good strategy to issue stock when the price is low because you have to sell too many shares to achieve your revenue goal and you inflict too much dilution on existing shareholders.

Third, the strategy might backfire if Pinnacle West issued stock without fixing the PWEC credit problem first. If PWEC were left unattended, Wall Street would have to view the stock issue as an investment in merchant generation, which at this time would not be well received.

For all of these reasons, a stock issue should be the very last resort.

Q. YOU MENTIONED MERCHANT GENERATORS. DO THEY HAVE A PLACE IN THIS PROCEEDING?

A. As far as AUIA is concerned, this is a matter between a regulated Arizona utility and its regulators. The merchants are essentially carpetbaggers and

they have no legitimate interest in this proceeding, but it's clear that they will be in evidence.

Q. WHAT DO YOU ANTICIPATE THEIR POSITION WILL BE?

A. They have certainly shown their cards in other proceedings. It is probable that they will urge the Commission to deny the financing application. As an alternative, they are likely to implore the Commission to adopt a list of onerous conditions like those advocated by Panda-Gila River for APS's emergency financing on Nov. 22.

Q. WHY WOULD THE MERCHANTS OPPOSE THIS APPLICATION?

A. They have had a tendency to talk about reducing the risk to ratepayers, but of course, they don't have any ratepayers. Nor will they, since the merchants are exempt wholesale generators that have no retail customers.

Q. DO THEY HAVE OTHER REASONS FOR OPPOSING THE APPLICATION?

A. It's obvious that they regard PWEC as competition, not only for APS's contestable load, but for electric loads throughout the west. They don't want PWEC to receive investment grade financing because it might provide PWEC with a competitive edge. Since most of the merchant generators no longer enjoy high credit ratings, they want PWEC to join them in the credit cellar.

Q. ISN'T IT FAIR FOR ALL UNREGULATED GENERATORS TO BE TREATED ALIKE?

A. Not in this case. There are significant differences in the circumstances of the merchant generators and that of PWEC, which the Commission should recognize.

Q. WHAT ARE THEY?

A. First, the Redhawk and West Phoenix plants were built to serve APS customers and they are doing that now. If Redhawk, for example, had been built to serve other markets, PWEC would have sold its output into the California forward market rather than reserving it to meet Arizona

needs. The merchant plants were planned to serve electric loads wherever they can find them, especially in California.

Second, the PWEC plants were built by an affiliate of APS, which has a continuing obligation to serve and to act as the provider of last resort to its customers. The merchants have no obligation to anyone in Arizona.

Third, every decision that led to the current financial crisis facing Pinnacle West and PWEC was made in the context of or in direct response to an order of the Commission.

Q. DO YOU HAVE A CONCLUDING STATEMENT?

A. For all of the reasons we have cited, including the well being of APS's customers, it is in the public interest for the Commission to rectify this situation by granting the financing application.

Q. DOES THAT END YOUR TESTIMONY?

A. Yes, it does.

INVESTORS QUARTERLY
ARIZONA UTILITY INVESTORS ASSOCIATION DECEMBER 2002

EXHIBIT
AUIA-2
Admitted
tabbies

# ELECTRIC UTILITIES FACE REGULATORY AND FINANCIAL QUICKSAND

As 2002 comes to a close, Arizona electric companies are coping with regulatory turmoil, relentless attacks from merchant generators and queasy financial reactions from banks and rating agencies.

Since September, a series of events has created unsettled business conditions for two of the state's major utilities: **Pinnacle West Capital Corp.** and its utility subsidiary, **Arizona Public Service Co.** (APS), and **UniSource Energy Corp.** and its subsidiary, **Tucson Electric Power Co.** (TEP):

- On Sept. 10, the Arizona Corporation Commission (ACC) reversed course on electric competition and prohibited the two utilities from transferring their generating plants to separate affiliated companies in 2003, as the Commission's own rules had required.
- The Commission's so-called Track A decision also partitioned about 1,700 megawatts (MW) of power plants worth about $1 billion from APS and left them without permanent financing, owned by a generation affiliate that has no access to credit.
- With the stroke of a pen, the ACC converted Pinnacle West and APS from a pure utility operation to a hybrid utility and merchant generator. The orphaned plants will have to stop serving APS customers next summer unless they win that right in competitive bidding against other merchant providers.
- As a result of the ACC action, Pinnacle West had to ask the Commission to allow APS to provide a $500 million line of credit to Pinnacle West to support the financing of the severed power plants. The ACC is scheduled to consider the request next month.
- In the meantime, Standard & Poor's, the influential credit rating agency, downgraded APS's corporate credit rating and lowered Pinnacle West's rating on senior unsecured debt. This caused Pinnacle West to lose a bank line of credit and created a cash crisis.
- Next, Pinnacle West filed an emergency application with the ACC for authority to borrow up to $125 million from APS to shore up cash flow until its $500 million financing application can be heard. The Commission quickly approved the short-term fix.
- Since then, Fitch Ratings has put the debt securities of APS and Pinnacle West on credit watch, warning that a credit downgrade will occur if Pinnacle West is unable to arrange new financing for its detached power plants.
- The Track A decision also required APS and TEP to submit their unmet electric needs — defined as what they can't supply with their owned assets — to competitive bidding.
- A separate proceeding, known as Track B, began last month to design the bidding process and determine how much of the utilities' load should be contestable.

Although TEP was largely unscathed in the Track A decision, it is more vulnerable to load-serving issues in Track B. In that proceeding, the ACC staff and merchant generators want to enlarge the amount of load that is contestable for both utilities beyond the terms of the Commission's September order. A Commission decision on Track B is expected in late January or February.

The Track A decision junked a settlement agreement that the Commission signed with APS in 1999 and which the financial community has relied on for the past three years to gauge Pinnacle West's finances. But the Commission and its staff are in deep denial that any of their actions have contributed to a negative financial environment for the utilities. They say they are simply trying to get bargain prices for electric consumers.

All of this is causing financial analysts, bankers and rating agencies to focus warily on Arizona, to see how many times and in how many ways the ACC is going to change the ground rules for Arizona utilities.

## Pressure From Merchant Power Plants

Merchant power generators that are building plants in Arizona are applying serious muscle in the ACC proceedings. Some have made it clear they will strongly oppose the APS financing application next month. They don't want the Pinnacle West generating plants to have better credit quality than they have and that is pretty bad.

Who are these merchant power generators?

They are mostly offshoots of out-of-state utility companies that decided in recent years to invest heavily in generating plants that would sell power into the wholesale market. A dozen companies plan to build about 40 units in Arizona totaling more than 14,000 MW, more capacity than serves the entire state today. Most have been approved for construction by the ACC.

The Arizona plants were planned primarily to serve California, but the wholesale market there has dried up. Many of these companies are in dire financial straits and are desperate to sell some power here to save their faltering projects.

Collectively, merchant generators have contributed significantly to the electric industry's descent into the financial cellar. They have carpeted the countryside with the residue of

*(Electric Companies continued on page 2)*

## Electric Companies

*(continued from page 1)*

bad business decisions, including billions of dollars worth of failed power projects.

Some have reneged on their debts and they have made junk credit ratings the new standard for the industry. They have been forced by lenders and rating agencies to dump excess generating assets into a glutted market, with untold effects on future energy production.

Here in Arizona, they preach the value of improved air quality because all of their plants will be fueled by natural gas, but they don't tell us that each one of these merchant plants will consume as much fuel annually as **Southwest Gas Corporation** uses to serve all of its Arizona customers.

Some of these plants have not planned for transmission capacity to get access to Phoenix, Tucson or any other market at peak consumption periods when additional power may be needed.

These companies are not regulated by the ACC and have no allegiance to Arizona. They will send their product elsewhere at the first sign of a West Coast market recovery. In the meantime, they will export over 100,000 acre-feet of Arizona water annually. They will suck up 20 times the amount of natural gas that Southwest Gas uses to serve all of its customers. And they will make the air dirtier than it was in a dozen Arizona locations. ■


### AUIA BOARD OF DIRECTORS

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## AUIA BOARD MEMBER IS RECOGNIZED FOR OUTSTANDING CONTRIBUTIONS

Long time AUIA Board member, **Albert L. McHenry, Ph.D.**, received the James H. McGraw Award at the Annual Conference of the American Society for Engineering Education. The award is presented to an outstanding contributor to engineering technology education.

McHenry is an expert in digital electronics and has focused much of his research on the improvement of engineering technology education, particularly for minorities. Since 1991, the National Science Foundation has awarded him more than $16 million in grant monies in support of these efforts.

McHenry is Dean of the College of Technology & Applied Sciences at Arizona State University East and was recognized for his contributions and service to engineering technology education for the past 36 years. He has helped make the College one of the top engineering technology schools in the nation. We add our congratulations to Dr. McHenry!

## CITIZENS SELLS ARIZONA GAS AND ELECTRIC OPERATIONS TO UNISOURCE

On October 29th, **UniSource Energy Corporation** announced an agreement to purchase **Citizens Communications'** gas and electric distribution assets in Arizona. UniSource, established in 1998, is the holding company for **Tucson Electric Power Co.** (TEP). UniSource said it will pay approximately $230 million in cash or about 50 percent of the book value of Citizens' properties.

The Arizona Corporation Commission (ACC), the U.S. Securities and Exchange Commission and the Federal Energy Regulatory Commission must approve the agreement. UniSource anticipates the purchase will be completed during the third quarter of 2003.

Utility sales are typically for more than book value, requiring the buyer to pay a premium. In this case, the low purchase price undoubtedly reflects major regulatory uncertainties that are confronting Citizens in Arizona. It may also foretell benefits to Citizens' electric and gas ratepayers.

Currently, Citizens has a $121 million deficiency in its Purchased Power and Fuel Adjustment Clause (PPFAC) that it incurred in serving electric customers in Mohave and Santa Cruz counties. It is trying to recoup the under collection in a case that has been creeping through Commission proceedings for fifteen months.

In addition, Citizens buys almost all of its electricity through a wholesale contract with **Pinnacle West Capital Corporation** that runs from June 2001 through May 2008. The contract is tied up in the PPFAC case and hasn't been approved by the ACC. Under the contract, Citizens pays about 1.8 cents per kWh more than it is allowed to collect from customers and it is costing Citizens more than $2 million per month on average.

Finally, Citizens recently filed a gas rate case with the ACC, seeking a 28.9 percent increase or about $21 million per year from its gas customers in Mohave, Yavapai, Coconino, Navajo, Apache and Santa Cruz counties.

According to a UniSource press release, "Citizens and UniSource Energy will assume joint responsibility for completing two utility rate cases Citizens has pending before the ACC."

What this may mean is that UniSource may try to use the value in its discounted purchase price to put together a settlement agreement on some or all of these pending issues that it can take to the ACC for its approval along with the acquisition itself.

UniSource said it will create a new subsidiary for the new assets and its rate structure will remain separate from that of TEP. TEP serves more than 350,000 customers in and around Tucson in southern Arizona. With the acquisition, UniSource will expand its customer base by more than 40 percent. For 2001, the Citizens operations generated approximately $175 million in revenue. UniSource expects the acquisition will add to its overall earnings within the first year. ■

# ROOSEVELT LAKE DECISION PENDING

AUIA's August newsletter described **Salt River Project's** bird dilemma at Roosevelt Lake. The big lake, which normally stores almost three quarters of the water SRP provides to Maricopa County, has dropped to less than 12 percent of its capacity due to several years of severe drought. As waters receded, scrubby foliage took root and the area has evolved into a seasonal home to the southwestern willow flycatcher...a bird on the Endangered Species List and as such, protected by federal law enforced by the U.S. Fish & Wildlife Service.

Fish & Wildlife proposed that once the drought breaks, SRP would not be permitted to fill the Lake beyond 40 percent of capacity because more would destroy the bird's newly found habitat. Water would be allowed to simply run downstream right through the middle of the population that needs it. One key consequence would be the need to tap underground wells, undermining state water policy, which hinges on preserving aquifers by reducing groundwater pumping.

SRP offered a mitigation strategy, the Roosevelt Lake Habitat Conservation Plan (HCP), which provides an appropriate balance by preserving most of the lake's storage capacity while minimizing lost bird habitat. Among other things, SRP would have to acquire and manage 1,500 acres of flycatcher habitat along several of Arizona's other rivers. That comes with a price tag for SRP of $20 to $30 million to preserve habitat for 292 migratory birds.

The flycatcher is a transient and whimsical species. It claims no territorial imperative or geographic loyalty. It goes wherever it finds suitable habitat. It may be here today and gone tomorrow. As a result, the science supporting creation or retention of habitat for this bird is somewhat thin.

However, AUIA feels that the public interest is best served by a plan that balances the requirements of federal law with the needs of the 1.6 million people who rely on SRP's system of dams and canals for water supplies in a desert environment.

Fish & Wildlife's response to the conservation plan has been generally positive, but an official agency decision is not expected until the end of this month or early in January. We'll keep you posted. ■

# MEXICANS PROTEST STEAM GENERATORS

Nothing is easy in the utility business.

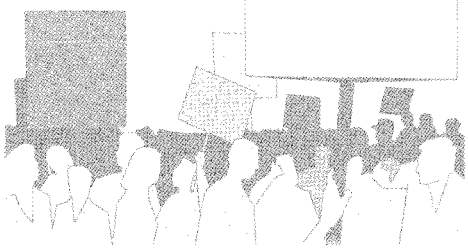
Last August *Investors Quarterly* described the need to replace two of the Palo Verde nuclear plant's steam generators due to hairline cracks in the tubing. The 800-ton generators are manufactured in Italy, shipped to a port in Mexico and transferred to special flatbed trucks which transport them at three miles per hour, mostly at night, over reinforced roads to the power plant 50 miles west of Phoenix.

But the delivery process has been delayed once due to protestors and could be delayed even longer. So what's the problem? Protestors say they're concerned about public exposure to radiation as the generators move from Puerto Peñasco (Rocky Point) through Mexico to Arizona.

In fact, this makes no sense. The new generators are hunks of metal with thousands of steel tubes that have been nowhere near a major source of radiation. They won't contain radioactive material after installation and even the old generators, after years of operation, give off virtually no radiation.

So what's the real problem? It appears to be politics, money or both.

An initial delay occurred when Puerto Peñasco Mayor Rodrigo Vélez Acosta asked **Arizona Public Service** (APS) to help build a community sports park. APS agreed and has also made road improvements and hired local workers for those jobs.



However, in October, members of the Partido del Trabajo (Labor Party) occupied the site where the special docks were being built to unload the generators. Protesters also appeared in Guaymas, where the generators were being stored until they could be unloaded, and at the Mexican port of entry in Nogales.

Jaime Moreno Berry, Sonora's delegate to the Labor Party's national committee, says that people's lives are being played with as long as the Mexican government doesn't provide the same assurances of safety offered by APS.

Other motives have been put forward. Faustino Felix Escalante, point man for the Sonoran governor, suggested the Labor Party is looking for visibility and support. The Party needs more than 1.5 percent of the vote in next year's national midterm elections or it will lose its official registration and public funding. And despite a request from Morena Berry for $500,000 each to five groups in exchange for passage of the generators, he denies money or politics are the reasons behind the protests.

The generators arrived in Puerto Peñasco early in November and are being transported, one at a time, on a route that takes them through the border town of Sonoita and on to the Palo Verde facility. ■

# HATCH-MILLER, GLEASON & IRVIN TAKE ACC SEATS

Some races were close, but winners have been declared and Arizona has two new Corporation Commission members and one returning Commissioner. In addition, the election produced a full boat of five Republicans, all from Maricopa County. Jim Irvin won the four-year term and will be returning to the Commission. Joining the Commission for two-year terms are two retiring legislators, Rep. Jeff Hatch-Miller and Rep. Mike Gleason. They will join Commissioners Bill Mundell whose term expires at the end of 2004 and Marc Spitzer whose term runs through 2006.

| Election Results | 2-Year Term | % | 4-Year Term | % |
|---|---|---|---|---|
| Hatch-Miller (R) | 556,189 | 28.0% | | |
| Gleason (R) | 511,801 | 25.8% | | |
| Cunningham (D) | 502,493 | 25.3% | | |
| James (D) | 414,849 | 20.9% | | |
| Irvin (R) | | | 572,556 | 51.2% |
| Walsh (D) | | | 545,508 | 48.8% |

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# 8TH ANNUAL MEETING BROUGHT CANDIDATES & VOTERS TOGETHER

The six candidates for Corporation showed their differences, the "creative" accounting practiced by companies such as Enron were described, the location was convenient and the food was great. All in all, AUIA's 8th Annual Membership meeting was deemed another successful event for the organization. This is a sampling of what attendees said about the both the seminar and the luncheon candidate panel program:

- Both speakers were excellent!!! Topics are right on target!
- Outstanding presentation! Very articulate and hand outs well worth keeping. Highly informative.
- Terrific speakers! Not long drawn out. Stayed in time limit.
- Excellent! Good presentation — very understandable. Presenters did good job.
- The private business sector has done an inadequate job of regulating itself. That was clearly exposed.
- Excellent — a much better way to gauge candidates positions than campaign coverage.
- Very informative. I got a good read of each candidate's position on the major issues.
- Good way to evaluate candidates before Nov. election.
- Enjoyed hearing candidates.
- This was a great opportunity to hear each candidate respond to the challenge presented by the ACC office. A good idea.
- Excellent program!
- Great lunch!
- Excellent location — enjoyed myself.
- This was an excellent location! Well handled and easy to access.
- This location is great and better than downtown and its cramped parking. Food outstanding. ■

# RUCO

# 1

EXHIBIT
RUCO-1
Admitted

IN THE MATTER OF THE ARIZONA PUBLIC SERVICE COMPANY'S RATE APPLICATION

DOCKET NO. E-01345A-02-0707

DIRECT TESTIMONY

OF

MARYLEE DIAZ CORTEZ

ON BEHALF OF

THE

RESIDENTIAL UTILITY CONSUMER OFFICE

DECEMBER 13, 2002

INTRODUCTION ..... 1
BACKGROUND ..... 2
IMPACT OF DYSFUNCTIONAL MARKETS ..... 5
RECOMMENDATION ..... 10

## INTRODUCTION

Q. Please state your name for the record.

A. My name is Marylee Diaz Cortez. I am a Certified Public Accountant. I am the Chief of Accounting and Rates for the Residential Utility Consumer Office (RUCO) located at 1110 W. Washington, Suite 220, Phoenix, Arizona 85007.

Q. Please state your educational background and qualifications in the field of utility regulation.

A. Appendix I, which is attached to this testimony, describes my educational background and includes a list of the rate case and regulatory matters in which I have participated.

Q. Please state the purpose of your testimony.

A. The purpose of my testimony is to present recommendations resulting from my review and analysis of Arizona Public Service Company's (Company or APS) application for approval of the issuance of long-term indebtedness and examine the transaction as it affects APS's parent company, Pinnacle West Capital Corporation (PWCC) and its unregulated generation subsidiary, Pinnacle West Energy Corporation (PWEC).

Q. How is your testimony organized?

A. First, I will provide some historical background information related to Arizona's efforts at restructuring its electric industry. Next, I will discuss how those historical events have lead us to the financing issue that is the subject of this docket. I will identify other problems (beyond the PWEC plant financing issue) that have arisen because a competitive retail electric market has failed to develop in the Southwest. Finally, I will discuss the need for a cohesive comprehensive solution to the problems that have arisen because a functional competitive electric market has failed to develop and make recommendations how to achieve those solutions.

**BACKGROUND**

Q. Please discuss the history of Arizona's efforts to restructure the regulation of the electric industry and move to a competitive electric market.

A. In May of 1994 the ACC Staff opened Docket No. RE-00000C-94-0165, *In the Matter of the Competition in the Provision of Electric Services Throughout the State of Arizona,* to study and consider electric restructuring for the State of Arizona. The Commission held workshops, public meetings, and hearings on the issue and adopted new rules A.A.C R14-2-1601 through R14-2-1616 (Competition Rules) on December 26, 1996 in Decision No. 59943. Several of the parties in the competition docket challenged the Competition Rules in the state courts. The Commission scheduled additional procedures (workshops, hearings,

public meetings) regarding the Competition Rules. In September of 1999 the Commission adopted revised Competition Rules.

Q. What did the revised Competition Rules provide?

A. The revised Competition Rules contained the following pertinent provisions:

1) All customers shall be eligible to obtain competitive electric services no later than January 1, 2001;
2) All competitive generation assets and competitive services shall be separated from the regulated utility prior to January 1, 2001. Such separation shall be to an unaffiliated third party or to a separate corporate affiliate(s);
3) After January 1, 2001, power purchased by a regulated distribution company for Standard Offer service shall be acquired from the competitive market through prudent, arm's length transactions, and with at least 50% through a competitive bid process.[1]

Q. Please continue discussing the history of electric restructuring in Arizona.

A. In October 2001, APS filed an application for a partial variance from the Competition Rules that required competitive procurement of power for Standard Offer customers, and for approval of a purchased power

[1] The 2001 dates referred to in items 2 and 3 were extended to January 1, 2003 for APS in Decision No. 61973.

agreement with the APS affiliate to which it was planning to transfer its generation assets. APS explained that the waiver application was necessary because of the instability of western wholesale electricity markets and imprudency of competitive acquisition of power in such a market.

In January and February 2002, the ACC Commissioners each issued letters seeking information pertaining to the restructuring of Arizona's electric industry. A new docket (E-00000A-02-051) was opened to examine electric restructuring issues, and to examine current events and how such events impacted the Competition Rules as well as the restructuring settlement agreements.

Q. Did the Commission grant APS its variance request?

A. Prior to considering the APS partial variance application and purchased power agreement, the Commission ordered that certain threshold issues (primarily wholesale market power and the transfer of generation assets) be considered in a "Track A" proceeding. Additionally, the Commission instructed the consideration of competitive solicitation in a "Track B" proceeding. A hearing on the Track A issues was held in June 2002 and a decision issued in September 2002. Track B issues have been examined in workshops and hearings. A Commission decision is pending.

On September 10, 2002 Decision No. 65154 was issued on the Track A proceeding. The order raised concerns that APS and TEP have market power in specific areas; that the wholesale electricity market applicable to Arizona is poorly structured and susceptible to possible malfunction and manipulation. The order concluded that the requirement that regulated electric utilities transfer their generation assets to others is not in the public interest at this time, and waives compliance with that rule.

**IMPACT OF DYSFUNCTIONAL MARKETS**

Q. How has APS been effected by the dysfunctional wholesale markets?

A. The ACC moved to protect customers from the dysfunctional markets by waiving/staying certain elements of the Competition Rules. Specifically, in Decision No. 65154 the Commission waived the requirement for APS to divest its generation assets.

Q. Why does the reversal of the divestiture requirement necessitate APS's financing request?

A. The APS financing application states, and RUCO agrees, that APS's generation subsidiary, Pinnacle West Energy Corporation (PWEC) is not creditworthy on a stand-alone basis. PWEC is incapable of securing financing on a stand-alone basis, given that Decision No. 65154 modified the Competition Rules so that APS could not divest generation to PWEC. The application requests ACC authority for APS to issue long-term debt,

which it would in turn loan to PWEC to support the long term financing of the PWEC owned generation assets. In the alternative the application requests authority for APS to guarantee the long-term indebtedness to support the PWEC generation assets.

Q. Are PWEC's credit problems attributable solely to the fact that it will not acquire the APS owned generation?

A. No. A number of factors are contributing to the problem. Many of these factors have arisen from the conditions that led the ACC to vacate the divestiture requirement.

Market conditions are not good for the energy sector. Near term power prices have declined over the past year or so and the power market in Arizona is over-built. Under such conditions, a stand-alone start up merchant generator with 2000 megawatts of uncommitted resources is considered high risk and unable to achieve an investment grade rating. APS acknowledges that under the current environment (i.e., no APS divestiture, glut of Arizona new generation plants, price of power, change in the status of California restructuring, the Enron market manipulations, etc.) PWEC would never have been created, nor would PWEC have built the generation assets it now holds.

APS further indicated in testimony and responses to data requests that the sale of the PWEC generation assets to a third party at this juncture would be "punitive". The economic value of the generation assets in today's market is significantly less than PWEC's cost to build these assets. The PWEC generation assets are therefore uneconomic under current circumstances.

Q. Is the uneconomic nature of the PWEC assets solely attributable to the modifications that Decision No. 65154 made to the Competition Rules?

A. No. PWEC's assets are uneconomic due to the same market factors discussed above that led the ACC to modify the Competition Rules in Decision No. 65154. While these factors are certainly important to understand, it is more important to recognize that because the assets are uneconomic a regulatory solution will be necessary for APS to effectively continue to serve the public needs.

Q. Why is the uneconomic state of the PWEC assets of concern to APS and APS ratepayers?

A. APS would not be concerned if PWEC were a stand-alone merchant generator whose venture failed and went bankrupt due to business risk. However, the uneconomic state of the PWEC assets *is* a regulatory concern because PWEC was created as a result a series of regulatory rules and decisions to move APS and the electric industry to competition.

Unfortunately, because a functionally competitive electric market has not developed, it is now necessary to rebuild the regulatory framework of the electric industry.

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

Further, the PWEC generation assets are not necessarily uneconomic for all time. Under evolving circumstances (i.e. load growth, a return to regulation, a reallocation of resources, etc.) the PWEC assets could become economic. Given this potential it would be unwise at this juncture to allow the collapse of PWEC and loss of the generation assets for pennies on a dollar.

In summary, rebuilding the electric industry to a regulated framework will be far less costly if reconstruction begins prior to the ultimate collapse.

Q. To what factors does APS attribute the uneconomic state of the PWEC generation assets?

A. In response to RUCO data request no. 3.5, which asked, "How much of the PWCC problem in refinancing the PWEC assts is attributable to the general credit markets for energy related companies and how much is attributable to the ACC's dramatic reversal of course on divestiture?" APS responded as follows:

> The problem is clearly attributable to both, and although the ACC's reversal of course was the precipitating event, it is not particularly relevant or helpful at the present time to attempt in some way to "allocate" responsibility for a single outcome to any one of its several contemporaneous causes, nor has APS attempted to do so. PWCC had planned to finance at PWEC, which after divestiture, would have been an investment grade company. Without investment grade credit ratings, PWEC is not able to access the capital markets. This then leaves the parent in the position of having to do the refinancing, which in turn could lead to credit rating downgrades. It is nevertheless also true that the general credit markets for energy related companies have been both volatile and shrinking for the past several months. There is a clear bifurcation of market participants in terms of credit spreads on existing and newly issued debt. Companies with fundamentally sound business models and little regulatory risk are still able to access the credit markets, albeit at a higher cost than earlier in the year. However, companies with any sort of material regulatory or business uncertainty (real or perceived) have been issuing debt at what would previously have been described as non-investment grade levels, if they are able to access the credit markets at all.

**RECOMMENDATION**

Q. Do you believe the APS proposed financing of the PWEC assets is the appropriate solution to the dysfunctional status of the western energy markets?

A. No. The APS proposed financing is merely a stopgap measure, which will serve only to prevent PWEC from defaulting on its short-term debt obligations and going into bankruptcy. What really is needed is a cohesive comprehensive plan to rebuild the regulatory paradigm and return the electric industry in Arizona to functional viability. The effect of Decision No. 65154 was not simply to stay divestiture, but to stay a move to reliance on a competitive wholesale electric market. The following language from Decision No. 65154 makes it clear a stay of competition in its entirety is intended:

> In retrospect it was a good idea to delay divestiture and competitive procurement in the APS and TEP Settlement Agreements, given what has happened in the last two or so years, including the experience in California; the market volatility and illiquidity; and the lack of public confidence in the transition to electric deregulation and the ability of regulators to prevent price spikes, ensure reliable service, and prevent bankruptcies. Even today, there is not agreement amongst economists, much less regulators, as to why what happened in California, happened, and how to prevent a similar or related occurrence.
>
> It is clear that the Commission and all parties expected benefits from retail competition, yet there is no active retail competition, so actual benefits are still unknown. It is said that consumers will benefit from wholesale competition, but not without the proper market structure and regulatory framework that will support it.

Q. Does APS itself recognize that its proposed financing is merely a stopgap and that ultimately we need to build a regulatory framework that will return the electric industry to functionality?

A. Yes. APS states at page 2 of its application that the financing application is just one step in the process of repairing the damage to the Company from the transitioning to and then the ultimate abandonment of a competitive electric industry.

Q. Why is it important to rebuild the electric industry framework and address the costs that were incurred in pursuit of a competitive industry sooner rather than later?

A. A significant amount of costs have already been expended on the transitioning to a competitive electric industry. As I testified in the Track A restructuring procedure, pursuant to the APS settlement agreement and the Financial Accounting Standard Board (FASB 71) APS has been deferring its cost of transitioning to a competitive electric industry for future recovery. Every day that the process of transitioning to a competitive electric market goes on, the costs continue to amass. In other words, the cost meter continues to tick as we speak. Therefore, the sooner the necessity of a regulatory reconstruction is recognized and acknowledged, the sooner the transition cost accruals will turn off. The piecemeal "step" procedure to mitigating the damages caused by a failed competitive electric industry, as proposed in the APS financing application, will merely

create additional problems, costs, and ultimately prolong and impede the necessary rebuilding of Arizona's electric regulatory framework.

Q. What issues will need to be examined and ultimately resolved as part of a regulatory reconstruction program?

A. The APS emergency financing order[2] had the effect of APS assuming financial liability for assets that it does not own and over which this Commission does not have jurisdiction. This is an extraordinary measure that in the absence of extraordinary circumstances never would have been considered. Accordingly, those assets now need to be transferred to APS and Commission jurisdiction. RUCO recommends that the Commission's approval of the Permanent Financing be conditioned on APS filing an application for the transfer of the PWEC generation assets to APS within 45 days of the issuance of a decision in this docket.

Once the PWEC generation assets are reunited with the APS debt a full examination of APS's cost of service in the context of a rate case is necessary. An APS rate case is scheduled for the near term. Decision No. 61978 requires APS to file a general rate case by June 30, 2003.

The scheduled rate case is timely since APS has not had a full rate investigation in over ten years, calling to question the reasonableness of

[2] Decision No. 65434, dated December 3, 2002.

today's rates. The rate case must 1) look at the costs that have been incurred to pursue a competitive electric industry and 2) determine an appropriate allocation of those costs. The rate case can determine which portion of the PWEC generation is used and useful and eligible for rate base treatment and which is uneconomic and therefore not eligible for rate base treatment. The rate case will ultimately resolve the manner in which uneconomic costs might be allocated among ratepayers and shareholders.

Arizona Administrative Code sections R14-2-1601 through R14-2-1618 should be revised consistent with the electric regulation reconstruction. Decision No. 65154 recognizes the need for a comprehensive review of the Competition Rules and has already instructed Staff to open a rulemaking docket to address any required changes to the rules.

Q. So you are recommending approval of the Permanent Financing?

A. Yes. However, this recommendation is dependent on the recognition that the financing is simply the first step to the ultimate reconstruction of electricity regulation. Without this understanding the proposed financing is not in the public interest, as it would assign APS a $500,000,000 liability for assets to which it does not hold title. Clearly, such an arrangement would not serve captive ratepayers interests in the long run.

Q. Does that conclude your direct testimony?

A. Yes.

## APPENDIX I

Qualifications of Marylee Diaz Cortez

**EDUCATION:** University of Michigan, Dearborn
B.S.A., Accounting 1989

**CERTIFICATION:** Certified Public Accountant - Michigan
Certified Public Accountant - Arizona

**EXPERIENCE:** Audit Manager
Residential Utility Consumer Office
Phoenix, Arizona 85007
July 1994 - Present

Responsibilities include the audit, review and analysis of public utility companies. Prepare written testimony, schedules, financial statements and spreadsheet models and analyses. Testify and stand cross-examination before Arizona Corporation Commission. Advise and work with outside consultants. Work with attorneys to achieve a coordination between technical issues and policy and legal concerns. Supervise, teach, provide guidance and review the work of subordinate accounting staff.

Senior Rate Analyst
Residential Utility Consumer Office
Phoenix, Arizona 85004
October 1992 - June 1994

Responsibilities included the audit, review and analysis of public utility companies. Prepare written testimony and exhibits. Testify and stand cross-examination before Arizona Corporation Commission. Extensive use of Lotus 123, spreadsheet modeling and financial statement analysis.

Auditor/Regulatory Analyst
Larkin & Associates - Certified Public Accountants
Livonia, Michigan
August 1989 - October 1992

Performed on-site audits and regulatory reviews of public utility companies including gas, electric, telephone, water and sewer throughout the continental United States. Prepared integrated proforma financial statements and rate models for some of the largest public utilities in the United States. Rate models consisted

of anywhere from twenty to one hundred fully integrated schedules. Analyzed financial statements, accounting detail, and identified and developed rate case issues based on this analysis. Prepared written testimony, reports, and briefs. Worked closely with outside legal counsel to achieve coordination of technical accounting issues with policy, procedural and legal concerns. Provided technical assistance to legal counsel at hearings and depositions. Served in a teaching and supervisory capacity to junior members of the firm.

## RESUME OF RATE CASE AND REGULATORY PARTICIPATION

| Utility Company | Docket No. | Client |
|---|---|---|
| Potomac Electric Power Co. | Formal Case No. 889 | Peoples Counsel of District of Columbia |
| Puget Sound Power & Light Co. | Cause No. U-89-2688-T | U.S. Department of Defense - Navy |
| Northwestern Bell-Minnesota | P-421/EI-89-860 | Minnesota Department of Public Service |
| Florida Power & Light Co. | 890319-EI | Florida Office of Public Counsel |
| Gulf Power Company | 890324-EI | Florida Office of Public Counsel |
| Consumers Power Company | Case No. U-9372 | Michigan Coalition Against Unfair Utility Practices |
| Equitable Gas Company | R-911966 | Pennsylvania Public Utilities Commission |
| Gulf Power Company | 891345-EI | Florida Office of Public Counsel |

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|---|---|---|
| Jersey Central Power & Light | ER881109RJ | New Jersey Department of Public Advocate Division of Rate Counsel |
| Green Mountain Power Corp. | 5428 | Vermont Department of Public Service |
| Systems Energy Resources | ER89-678-000 & EL90-16-000 | Mississippi Public Service Commission |
| El Paso Electric Company | 9165 | City of El Paso |
| Long Island Lighting Co. | 90-E-1185 | New York Consumer Protection Board |
| Pennsylvania Gas & Water Co. | R-911966 | Pennsylvania Office of Consumer Advocate |
| Southern States Utilities | 900329-WS | Florida Office of Public Counsel |
| Central Vermont Public Service Co. | 5491 | Vermont Department of Public Service |
| Detroit Edison Company | Case No. U-9499 | City of Novi |
| Systems Energy Resources | FA-89-28-000 | Mississippi Public Service Commission |
| Green Mountain Power Corp. | 5532 | Vermont Department of Public Service |
| United Cities Gas Company | 176-717-U | Kansas Corporation Commission |

| | | |
|---|---|---|
| General Development Utilities | 911030-WS & 911067-WS | Florida Office of Public Counsel |
| Hawaiian Electric Company | 6998 | U.S. Department of Defense - Navy |
| Indiana Gas Company | Cause No. 39353 | Indiana Office of Consumer Counselor |
| Pennsylvania American Water Co. | R-00922428 | Pennsylvania Office of Consumer Advocate |
| Wheeling Power Co. | Case No. 90-243-E-42T | West Virginia Public Service Commission Consumer Advocate Division |
| Jersey Central Power & Light Co. | EM89110888 | New Jersey Department of Public Advocate Division of Rate Counsel |
| Golden Shores Water Co. | U-1815-92-200 | Residential Utility Consumer Office |
| Consolidated Water Utilities | E-1009-92-135 | Residential Utility Consumer Office |
| Sulphur Springs Valley Electric Cooperative | U-1575-92-220 | Residential Utility Consumer Office |
| North Mohave Valley Corporation | U-2259-92-318 | Residential Utility Consumer Office |
| Graham County Electric Cooperative | U-1749-92-298 | Residential Utility Consumer Office |

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|---|---|---|
| Graham County Utilities | U-2527-92-303 | Residential Utility Consumer Office |
| Consolidated Water Utilities | E-1009-93-110 | Residential Utility Consumer Office |
| Litchfield Park Service Co. | U-1427-93-156 & U-1428-93-156 | Residential Utility Consumer Office |
| Pima Utility Company | U-2199-93-221 & U-2199-93-222 | Residential Utility Consumer Office |
| Arizona Public Service Co. | U-1345-94-306 | Residential Utility Consumer Office |
| Paradise Valley Water | U-1303-94-182 | Residential Utility Consumer Office |
| Paradise Valley Water | U-1303-94-310 & U-1303-94-401 | Residential Utility Consumer Office |
| Pima Utility Company | U-2199-94-439 | Residential Utility Consumer Office |
| SaddleBrooke Development Co. | U-2492-94-448 | Residential Utility Consumer Office |
| Boulders Carefree Sewer Corp. | U-2361-95-007 | Residential Utility Consumer Office |
| Rio Rico Utilities | U-2676-95-262 | Residential Utility Consumer Office |
| Rancho Vistoso Water | U-2342-95-334 | Residential Utility Consumer Office |
| Arizona Public Service Co. | U-1345-95-491 | Residential Utility Consumer Office |
| Citizens Utilities Co. | E-1032-95-473 | Residential Utility Consumer Office |
| Citizens Utilities Co. | E-1032-95-417 et al. | Residential Utility Consumer Office |

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|---|---|---|
| Paradise Valley Water | U-1303-96-283 &<br>U-1303-95-493 | Residential Utility<br>Consumer Office |
| Far West Water | U-2073-96-531 | Residential Utility<br>Consumer Office |
| Southwest Gas Corporation | U-1551-96-596 | Residential Utility<br>Consumer Office |
| Arizona Telephone Company | T-2063A-97-329 | Residential Utility<br>Consumer Office |
| Far West Water Rehearing | W-0273A-96-0531 | Residential Utility<br>Consumer Office |
| SaddleBrooke Utility Company | W-02849A-97-0383 | Residential Utility<br>Consumer Office |
| Vail Water Company | W-01651A-97-0539 &<br>W-01651B-97-0676 | Residential Utility<br>Consumer Office |
| Black Mountain Gas Company<br>Northern States Power Company | G-01970A-98-0017<br>G-03493A-98-0017 | Residential Utility<br>Consumer Office |
| Paradise Valley Water Company<br>Mummy Mountain Water Company | W-01303A-98-0678<br>W-01342A-98-0678 | Residential Utility<br>Consumer Office |
| Bermuda Water Company | W-01812A-98-0390 | Residential Utility<br>Consumer Office |
| Bella Vista Water Company<br>Nicksville Water Company | W-02465A-98-0458<br>W-01602A-98-0458 | Residential Utility<br>Consumer Office |
| Paradise Valley Water Company | W-01303A-98-0507 | Residential Utility<br>Consumer Office |
| Pima Utility Company | SW-02199A-98-0578 | Residential Utility<br>Consumer Office |
| Far West Water & Sewer Company | WS-03478A-99-0144<br>Interim Rates | Residential Utility<br>Consumer Office |
| Vail Water Company | W-01651B-99-0355<br>Interim Rates | Residential Utility<br>Consumer Office |

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|---|---|---|
| Far West Water & Sewer Company | WS-03478A-99-0144 | Residential Utility Consumer Office |
| Sun City Water and Sun City West | W-01656A-98-0577 & SW-02334A-98-0577 | Residential Utility Consumer Office |
| Southwest Gas Corporation<br>ONEOK, Inc. | G-01551A-99-0112<br>G-03713A-99-0112 | Residential Utility Consumer Office |
| Table Top Telephone | T-02724A-99-0595 | Residential Utility Consumer Office |
| U S West Communications<br>Citizens Utilities Company | T-01051B-99-0737<br>T-01954B-99-0737 | Residential Utility Consumer Office |
| Citizens Utilities Company | E-01032C-98-0474 | Residential Utility Consumer Office |
| Southwest Gas Corporation | G-01551A-00-0309 & G-01551A-00-0127 | Residential Utility Consumer Office |
| Southwestern Telephone Company | T-01072B-00-0379 | Residential Utility Consumer Office |
| Arizona Water Company | W-01445A-00-0962 | Residential Utility Consumer Office |
| Litchfield Park Service Company | W-01427A-01-0487 & SW-01428A-01-0487 | Residential Utility Consumer Office |
| Bella Vista Water Co., Inc. | W-02465A-01-0776 | Residential Utility Consumer Office |
| Generic Proceedings Concerning Electric Restructuring Issues | E-00000A-02-0051 | Residential Utility Consumer Office |

# S

# 1, 2, and 4

EXHIBIT
S-1
admitted

**BEFORE THE ARIZONA CORPORATION COMMISSION**

WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

| | |
|---|---|
| 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; AND TO GUARANTEE THE OBLIGATIONS OF AN AFFILIATE OR AFFILIATES ) | DOCKET NO. E-01345A-02-0707 |

DIRECT

TESTIMONY

OF

JOHN S. THORNTON, JR.

CHIEF, FINANCIAL & REGULATORY ANALYSIS SECTION

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

DECEMBER 13, 2002

# EXECUTIVE SUMMARY
# ARIZONA PUBLIC SERVICE COMPANY
# DOCKET NO. E-01345A-02-0707

On September 11, 2002, Arizona Public Service Co. ("APS") filed an application pursuant to Arizona Revised Statutes ("ARS") §§ 40-285, 40-301, *et seq.* and Arizona Administrative Code ("AAC") R-14-2-804 for authority to borrow $500,000,000 of debt and lend it to Pinnacle West Capital Corp. ("PWCC") or Pinnacle West Energy Corp ("PWEC"). The application also requests authority to guarantee PWCC or PWEC obligations in the same amount, or a combination of loans and guarantees. On October 11, 2002, APS filed testimony by Mr. Arthur H. Tildesley and Ms. Barbara M. Gomez in support of the application.

The primary goal of the loan or guarantee is to refinance or facilitate the refinancing of Bridge Debt incurred by PWCC to construction finance PWEC assets. That Bridge Debt must be largely refinanced in 2003. APS asserts that neither PWCC nor PWEC is in a position to issue public debt to refinance the maturing Bridge Debt without an APS guarantee, or otherwise by simply borrowing from APS who would issue debt publicly.

APS asserts that the application was filed to address the "serious and unique financial harm faced by APS, PWEC, and Pinnacle West as a result of the Commission's 'reversal of course' on the issue of APS generation and divestiture." Staff does not view the Commission's actions as the cause of PWEC's near-term capital requirements and this application. PWEC faces problems endemic in the merchant energy sector.

Staff finds that APS should be authorized to issue and sell $500,000,000 of debt and to loan the proceeds to PWEC pursuant to seven conditions. Staff does not recommend that APS be authorized to loan proceeds to PWCC. Nor does staff recommend a guarantee of either PWEC or PWCC debt.

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## INTRODUCTION

**Q. Please state your name, occupation, and business address.**

A. My name is John S. Thornton, Jr. I am the Chief of the Financial and Regulatory Analysis Section of the Utilities Division ("Staff"), Arizona Corporation Commission ("ACC" or "Commission"). My business address is 1200 West Washington Street, Phoenix, Arizona 85007.

**Q. Please describe your educational background and professional experience.**

A. See my Witness Qualifications Statement, attached as Exhibit JST-1 to JST-2.

**Q. What is the purpose of your testimony?**

A. The purpose of my testimony is to respond to Arizona Public Service Company's ("APS") application, filed on September 11, 2002, for approval to issue debt for the purpose of lending the proceeds to Pinnacle West Capital Corporation ("PWCC") or Pinnacle West Energy Corporation ("PWEC"); or to guarantee PWCC/PWEC's debt, or both. I also address APS' testimonies filed by Mr. Arthur H. Tildesley and Ms. Barbara M. Gomez, filed on October 11, 2002.

## SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

**Q. Briefly summarize your conclusions and recommendations.**

A. I conclude that the Commission should only authorize APS to issue debt in order to loan the proceeds to PWEC. APS has significant needs for capital for regulated utility operations over the coming years and issuing debt to loan to PWEC or PWCC will diminish APS' ability (bonding capacity) to obtain APS' own required debt capital. Therefore, conditions are necessary to mitigate any harm.

## ANALYSIS

**Q. Please generally describe the transactions for which APS seeks authority.**

A. APS seeks authority to engage in one or a combination of the following activities:

(1) Financing proposal: APS issues $500,000,000 of secured or unsecured debt and loans the proceeds to PWEC or PWCC.

(2) Guarantee proposal: APS guarantees $500,000,000 of PWEC or PWCC debt that those entities would issue independently.

### Financial Markets' Reaction and Regulatory Insulation

**Q. How would the financial markets generally view the effect on APS' stand-alone credit quality of a $500,000,000 loan to PWEC/PWCC, or a guarantee of PWCC/PWEC debt in the same amount.**

A. The financial markets, notably the rating agencies, generally would favor a regulated public utility being increasingly insulated from the non-regulated activities of a parent or its affiliates, and this insulation translates into better credit ratings for the regulated public utility. APS' proposal would increasingly mix APS' regulated activities with PWCC's nonregulated activities. Below is a quote from Standard & Poor's:

> Talk of isolating a utility from the parent company's unregulated activities could be signaling a trend that greater regulation of utilities is back in vogue, which is quite the opposite of one of the reasons — less regulation — why electric restructuring was instituted. Standard & Poor's Ratings Services has long-held a view of a lack of regulatory insulation from nonregulated operations and diminishing regulatory support for utility credit quality, which has caused many ratings downgrades over the past few years. **Therefore, any action that state regulators take that provides support (whether legal, regulatory, financial, or operational) to the utility and/or isolates the utility (most importantly financial obligations) from its parent company will be positive for credit....Thus, credit ratings of regulated utility companies are affected by the parent company's nonregulated businesses. Only when sufficient regulatory insulation exists will the corporate credit rating (risk of default) of an operating company be separated from that of the holding company.**

(emphasis added)

APS' request to borrow money to loan PWEC/PWCC runs counter to the goal of insulating APS from its holding company's nonregulated activities. I attach the full Standard & Poor's report as Exhibit JST-3 to JST-4. The Commission should pursue the goal of regulatory insulation in this docket.

**Comment on ACC Actions and the Application**

**Q. Is the situation PWEC faces unique to it or actions taken by the ACC?**

A. No, this situation is not unique to PWEC and the ACC. A S&P report, included as exhibit JST-5 to JST-8, indicates that the United States has faced an unprecedented level of power plant construction that was financed with short-term construction or "mini-perm" financings. S&P estimates that about $30,000,000,000 to $50,000,000,000 of construction or mini-perm financings will mature and have to be successfully refinanced in the 2003-2007 period. S&P reports that according to one source, about 80 gigawatts of electric capacity were completed or [were] in some form of construction over the past three years. PWEC chose to finance its construction with near-term debt, and it faces problems endemic in the merchant energy sector.

**Financing Proposal**

**Q. What are the standards by which the Commission evaluates a financing application?**

A. The standards are found in Arizona Revised Statute 40-301(C):

> 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.

**Q. Please address Staff's analysis of the standards and the facts of this case. Is the financing proposal for lawful purposes?**

A. I am not a lawyer, but I do not understand the purposes to be unlawful. However, from a regulator's point of view, borrowing capital to lend to an affiliate is not obviously consistent with the provision of utility service. Below, I discuss how the transaction could be considered consistent with provision of utility service because the transaction eventually supports APS' credit rating by providing support to its affiliates.

**Q. Is the financing proposal compatible with the public interest?**

A. I do not perceive the financing proposal as obviously compatible with the public interest without Commission conditions because APS would be incurring a large liability when it needs to seek and obtain debt capital for its own utility-related capital expenditures. I discuss APS' capital investment requirements below. However, PWCC has indicated that if PWCC/PWEC do not secure a loan or guarantee from APS then PWCC's credit ratings will fall. That decline would drag down APS' ratings as well. The requested authorization would, therefore, be consistent with the public interest if it ultimately helped to prevent a decline in APS' credit ratings.

The public interest standard is also cited in Arizona Administrative Code R-14-2-806, the rule that governs waiving Arizona Administrative Code R-14-2-804 under which the application was filed.

**Q. Is the financing proposal compatible with sound financial principles?**

A. The proposed financing is not obviously consistent with sound financial principles because APS would be taking on $500,000,000 of debt without any corresponding utility assets. It will receive a note from PWEC or PWCC and payments that should cover the note's interest and principal. However, it is not necessarily a sound financial practice for

APS to use its bonding capacity (the extent to which APS can issue secured debt) for the purpose of purely investing in an affiliate without any business purpose consistent with APS' primary mission. The financing can be more likely expected to impair APS' ability to perform its service than to improve it. The impairment comes about because APS has a limited bonding capacity or ceiling within which it can issue debt. Bonding capacity is explicitly dictated by debt covenants and implicitly by the capital markets. APS' issuance of $500,000,000 in addition to its existing $2,200,754,000[1] represents an approximate 22 percent increase in debt without any corresponding increase in revenue-producing utility assets.

**Q. Is the financing proposal compatible with the proper performance by the applicant of service as a public service corporation and will the financing not impair APS' ability to perform that service?**

A. The financing is not obviously compatible with APS' proper performance as a *public service company* without conditions because APS is not primarily in the banking business, which is essentially the activity it requests in this docket through the financing request. However, as I discussed above in addressing the public interest, the transaction could be considered consistent with provision of utility service because the transaction eventually supports APS' credit rating by providing support to its affiliates. In this light, the transaction could be considered compatible with APS' public service obligation.

**Q. Does APS have capital expenditure requirements of its own for which it needs its bonding capacity?**

A. Yes. APS has significant expected capital expenditures on "delivery" (transmission, distribution, etc.) in order to serve native load. I do not recommend that the Commission encourage APS to impair the utility's ability to properly finance its capital expenditures

[1] Source: APS' form 10-Q filed on November 14, 2002, with the SEC for the period ending September 30, 2002.

into the future by issuing debt on behalf of PWEC or PWCC without significant conditions.

**Q. Are PWCC and PWEC already implicitly subsidized by APS?**

A. Yes. PWCC and PWEC are already provided a certain amount of credit support from APS through the holding company structure. Practically speaking, the markets are aware that PWCC has access to APS' cash flows and the markets rate PWCC accordingly. PWEC benefits as well by being owned by PWCC and can draw on APS through PWCC. Contractually locking in that implicit cross subsidization with an explicit loan agreement would be a step backward for public policy without mitigating conditions.

**Q. What would be an outcome if PWCC or PWEC defaulted on their debts to APS?**

A. APS would have to continue to make the interest and principle payments on the $500,000,000 of debt it issued to the market and APS would have a $500,000,000 non-performing asset on its books. The application is vague on whether the loan from APS to PWCC or PWEC will be secured by PWEC's assets or not. Moreover, PWEC is expected to pay a $500,000,000 dividend to PWCC and will not, therefore, have cash on hand to repay the debt. PWEC could default on its loan to APS and yet PWEC could retain the assets. The debt and the assets should normally be held by the same enterprise to be consistent with sound financial principles.

**Q. Should APS theoretically lend money to PWEC at APS' borrowing rate or at a rate consistent with PWEC's competitive-market cost of debt?**

A. APS should earn a return on any investment commensurate with that investment's risk. If PWEC's debt rating is below investment grade then APS should theoretically lend money to PWEC at PWEC's competitive-market below-investment-grade cost of debt. The spread between APS' lower cost of borrowed funds and PWEC's higher cost of borrowed

funds is simply compensation for risk to make APS whole on an expected basis. The PWEC market-based interest rate should be applied on the note even if APS lends to PWCC so that the appropriate risk is isolated and priced accordingly. Staff does not recommend a loan to PWCC, however. I proposal a condition to address my concern that specifies a specific interest rate spread above APS' cost of debt. The 264 basis-point spread[2] that I propose incorporates an implicit BB- rating for PWEC. The BB- (S&P) rating is at the low end of the BB series and is below investment grade, resulting in a significantly higher coupon on the APS loan to PWEC than on the APS debt to the public.

**Guarantee Proposal**

**Q. What are the standards by which the Commission can approve the guarantee?**

A. The guarantee operates much like an evidence of indebtedness, so its standards would be the same as found in Arizona Revised Statute § 40-301(C) that I discussed above. In addition, the guarantee might encumber utility assets.

**Q. What exact terms does APS propose for the guarantee and what do you recommend regarding its authorization?**

A. The guarantee is undefined and unpriced in the application. By unpriced I mean that the nature of compensation for the guarantee is unaddressed. This lack of definition makes the guarantee proposal untenable at this time. Staff prefers an explicit loan at a stated interest rate that appropriately prices the risk to which APS is exposed.

**COMMENT ON THE TESTIMONY OF ARTHUR H. TILDESLEY**

**Q. What is the purpose of Mr. Tildesley's testimony?**

[2] I calculated the 264 basis-point spread from Bloomberg data on the difference in spreads above Treasury between BB-rated securities (PWEC's implied rating at a 383-point spread) and BBB2-rated securities (APS' rating at a 119-point spread). The data are likely for unsecured spreads which would increase for strictly BB- but decrease for a security interest. Therefore, Staff takes the resulting calculation to be a not unrepresentative proxy for a BB- secured spread. Staff could amend this calculation if it obtains more recent or better data closer to hearing.

A. The purpose of Mr. Tildesley's testimony is to answer four questions regarding the impact of the loan or guarantee on APS. He concludes that PWEC is unable to raise significant debt financing on a stand-alone or non-recourse basis and that APS has sufficient (indeed "excess") credit capacity to provide a $500 million loan or guarantee to PWEC without impairing the fundamental utility credit quality. (*See* testimony of Arthur Tildesley, pages 5 and 9.)

**Q. Do you agree with Mr. Tildesley's conclusions?**

A. No, I do not agree with Mr. Tildesley's conclusions. I find that the potential reduction in APS' financial ratios is significant and would negatively impact the Company.

**Q. On page 5 of his testimony, Mr. Tildesley states, "Under current market conditions, PWEC would be unable to raise significant debt financing on a standalone or non-recourse basis." Did you inquire into the basis of his statement?**

A. Yes, I did. I found that his statement was not supported by any documentation of PWEC efforts to raise significant debt financing. Rather, Mr. Tildesley relied on Solomon Smith Barney's existing and accumulated knowledge. (See Exhibit JST-9.)

**Q. Has Solomon Smith Barney published any credit reports on APS, PWEC, or PWCC?**

A. No, Solomon Smith Barney has not published any credit reports for the companies over the past three years. This lack of established research and publication calls into question Solomon Smith Barney's qualification to make a current credit finding before the Commisson. (See Exhibit JST-10.)

**Q. What evidence does Mr. Tildesley offer to support his claim that "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." (See Testimony of Arthur Tildesley, page 9.)**

A. He presents certain credit statistics for APS compared to S&P benchmarks, reproduced below:

**Figure 2. Credit Statistics for APS**

| | | | | |
|---|---|---|---|---|
| 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 Capitalizatior | 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.

I find that a *decline* in credit quality is demonstrated in Mr. Tildesley's credit indicator calculations. The mere fact that the resulting credit statistics remain above the S&P benchmarks does not mean that credit quality has not been harmed; rather, it simply means that APS would likely not face an immediate rating downgrade. I view the potential decline in EBIT/Interest ratio from 4.5x to 3.2x to be particularly significant and meaningful.

**Q. On page 11 of his direct testimony, Mr. Tildesley states, "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." What analysis did he do to support his conclusion, and how much excess debt capacity does APS have?**

A. Mr. Tildesley's analysis appears limited to the table of statistics above. He cannot quantify how much excess debt capacity APS currently has. (See exhibit JST-11 to JST-13.)

**Q. Mr. Tildesley also concludes on page 11 of his testimony that the credit quality of PWCC will suffer if PWEC is not able to obtain new financing on a non-recourse basis. He also states that PWEC does not have access to third-party debt financing on a non-recourse basis in any meaningful amount. How do you respond?**

A. His statements, as I have discussed, are speculative and unsupported by documentation.

**COMMENT ON THE TESTIMONY OF BARBARA M. GOMEZ**

**Q. What is the purpose of Ms. Gomez' testimony?**

A. The purpose of Ms. Gomez' testimony is to show that PWEC required transfer of APS' assets in order to sustain an investment-grade debt rating and that APS has significant unutilized financing capability to borrow from the markets and lend to PWCC or PWEC. (*See* testimony of Barbara Gomez, page 2 at 16 and page 4 at 1.)

**Q. Do you necessarily agree that the Commission's decision to prevent the transfer of assets from APS to PWEC caused PWEC/PWCC's need to request the authority to borrow from APS?**

A. No, I do not. PWEC might have transferred the assets to APS and received payment from APS, subsequently using the payment to pay off the Bridge Debt. PWCC freely chose the terms and maturity of the Bridge Debt and agreed to them when that debt was first issued. PWEC's choice of maturity has caused the sizeable refunding obligation to occur in 2003, rather than any particular ACC action.

**Q. What evidence does Ms. Gomez present to demonstrate that the proposed financing will not impair APS' ability to issue debt for its own purposes?**

A. Ms. Gomez presents a financial analysis in her exhibit BMG-3 that shows no effect on APS if it issued $500,000,000 of debt and lend it to PWEC/PWCC.

**Q. Do you agree with her analysis?**

A. No, I do not. Her analysis shows that borrowing $500,000,000 from the market and lending it to PWEC/PWCC is a "wash" transaction having no effect on APS' financial ratios. Under this analysis, APS could borrow and relend infinite amounts of debt as long as the lending rate was equal to the borrowing rate. I do not agree that the market would allow APS to enter into such transactions without an eventual decrease in its bond rating and, finally, an impairment of its access to capital.

## CONDITIONS OF APPROVAL

**Q. What conditions do you propose the Commission adopt in authorizing APS to borrow up to $500,000,000 and lend it to PWEC?**

A. I propose the following conditions:

(1) APS should be authorized to issue and sell no more than $500,000,000 of debt in addition to its current authorizations.

(2) The debt to be lent to PWEC should be no more than $500,000,000 of secured callable notes from PWEC. The security interest shall be on the same terms as the security interest APS already has pursuant to the $125,000,000 loan authorization from Decision No. 65434.

(3) The PWEC secured note coupon shall be 264 basis points above the coupon on APS debt issued and sold on equivalent terms (including but not limited to maturity and security).

(4) The difference in interest income and interest expense should be capitalized as a deferred credit and used to offset rates in the future. The deferred credit balance shall bear an interest rate of 6 percent.

(5) The PWEC debt's maturity shall not to exceed 4 years, unless otherwise ordered by the Commission.

(6) Any demonstrable increase in APS' cost of capital as a result of the transaction (such as from a decline in bond rating) will be extracted from future rate cases.

(7) APS shall maintain a minimum common equity ratio of 40 percent and shall not be allowed to pay dividends if such payment would reduce its common equity ratio below this threshold, unless otherwise waived by the Commission. The Commission will process the waiver within sixty days, and for this sixty-day period this condition shall be suspended. However, this condition shall not be permanently waived without an order of the Commission.

**Q. What is Staff's recommendation regarding the guarantee?**

A. The guarantee was not well defined in the application and remains unclear as to APS' actual liability and how such liability would be priced or enforced. Staff recommends that the guarantee option be denied. The loan option is clear, defined, and explicitly compensates APS for its risk exposure through a market-based mechanism (a rate of return on its investment in PWEC consistent with PWEC's presumed bond rating and market rates). Staff might consider recommending a guarantee if it were more clearly defined and priced. However, Staff does not believe that the guarantee is APS' preferred option, so such authorization might be moot.

**Regulatory Insulation**

**Q. What are conditions six and seven intended to accomplish?**

A. Conditions six and seven are intended to establish some regulatory insulation between APS and PWCC. In Order No. 65434, Docket No. E-01345A-02-0840, the Commission indicated that it would examine regulatory insulation measures in this docket.

**Q. Do you recommend that conditions six and seven continue until further order of the Commission?**

A. Yes, I do. Conditions six and seven should continue indefinitely in order to rectify the regulatory insulation problem that aggravated the current circumstances.

**Q. What is APS' current capital structure?**

A. APS had approximately 50 percent debt, 50 percent equity as of September 30, 2002, according to its "10-Q" filing with the Securities and Exchange Commission. The 40 percent minimum equity threshold allows for a significant margin from APS' current position but is a meaningful threshold to provide some regulatory insulation.

**Q. What would APS' capital structure be if it were to issue and sell an additional $500,000,000 of debt?**

A. APS' capital structure would be approximately 55 percent debt and 45 percent equity.

**Q. Do you consider a 55 percent debt/45 percent equity capital structure appropriate for a regulated electric utility?**

A. Yes, I view the resulting capital structure as appropriate.

**Q. Have you had an opportunity to discuss the application with APS?**

A. Yes, I have had several occasions to discuss the application with APS to understand, analyze, clarify, and narrow the issues in this case.

## CONCLUSIONS AND RECOMMENDATION

**Q. What do you conclude from your review of the Company's application and testimony and your own independent analysis?**

A. I conclude that APS should be granted authority to issue and sell no more than $500,000,000 of debt and to lend the proceeds to PWEC subject to the conditions I discuss above.

**Q. What is the appropriate long-term outcome for the financing and refinancing PWEC assets if they are to remain independent of APS?**

A. PWCC should issue debt or equity and infuse PWEC with capital if it wants to capitalize this non-regulated unit as a going concern. The capitalization of PWEC should not, in the long run, directly involve APS if PWEC is to remain independent.

**Q. Does this conclude your prepared direct testimony?**

A. Yes, it does.

# Witness Qualifications Statement

NAME: JOHN S. THORNTON, JR.

ADDRESS: 1200 West Washington St. Phoenix, AZ 85007

EDUCATION: Master of Science Degree from the University of London, having completed the graduate program in economics at The London School of Economics and Political Science (1986)

Graduate Diploma in Economics from The London School of Economics (1985).

Bachelor of Arts degree, major in economics, from Willamette University (1984).

Certified Rate of Return Analyst, member of the Society of Utility and Regulatory Financial Analysts.

1998 passed level I of the CFA
1995 PaineWebber Seminar on Corporate Finance for the Utility Industry.
1990 MIT/Harvard Public Disputes Resolution Program seminar.
1990 National Association of Regulatory Utility Commissioners (NARUC) Advanced Regulatory Studies Program.
1988 NARUC Annual Regulatory Studies Program.

EXPERIENCE: Chief, Accounting & Rates, Arizona Corporation Commission, 2001 to present.

Senior Analyst with the Public Utility Commission of Oregon, 1988-2001.

Testified or provided rate of return analyses in the following dockets:

- UE 102—PGE disaggregation/general rate case (chief rate of return witness).
- UE 94—PacifiCorp general rate case (chief rate of return witness).
- UE 93 (UM 592, UM 694)—Portland General Electric Co. excess power cost/Coyote/BPA filing.
- UE 92—Idaho Power general rate case.
- UE 88—Portland General Electric Co. general rate case (chief rate of return witness).
- UE 85/UM 529—Portland General Electric Co. Earnings test for Trojan Shutdown Cost Adjustment Account.
- UE 84—Idaho Power Co. deferred account earnings benchmark.
- UE 82/UM 445—Trojan Outage Cost Adjustment Account earnings test benchmark.
- UE79—Portland General Electric Co. general rate case (chief rate of return witness).
- UG 104/UG 105/UG 106—LDC deferred account earnings test benchmarks.

## Witness Qualifications Statement (continued)

UG88—Cascade Natural Gas Co. general rate case (chief rate of return witness).
UG81—Northwest Natural Gas Co. general rate case (chief rate of return witness).
UT 125—US WEST Communications, Inc general rate case (chief rate of return witness).
UT 113—GTE Northwest general rate case (chief rate of return witness).
UT101—United Telephone Co. of the Northwest general rate case (chief rate of return witness).
UT85—US WEST general rate case (capital structure and debt cost witness).
RP95-409—Northwest Pipeline general rate case (FERC).
RP93-5—Northwest Pipeline general rate case (FERC).

Responsibilities have also included the following:
Analyses and recommendations in over fifty financing dockets.
UM 903— Northwest Natural, cost of capital analysis for purchased gas adjustment mechanism
UM 21—Cost of capital analysis for avoided cost calculations.
UM 351—Cost of capital analysis for long-run incremental-cost studies.
UM 573—Analysis of purchased power on the utility's cost of capital.
UM 773—Cost of capital analysis for long-run incremental-cost studies.
UM 814—Enron's application to acquire Portland General Electric Co..
UM 918—Scottish Power plc's application to acquire PacifiCorp.
UM 967—Sierra Pacific Resource's application to acquire Portland General Electric Co.

Speaker—US Agency for International Development's Conference on Private Sector Participation in the Colombian Power Sector.

Presented beta adjustment and distribution risk discount testimony on behalf of the Division of Ratepayer Advocates of the California Public Utility Commission, Application Nos. 98-05-019, 021, & 024.

Rate of return witness for Mirage Resorts, Inc., Park Place Entertainment Corp., and the Mandalay Group, Sierra Pacific Power Co. compliance filing docket no. 99-4001 and Nevada Power Co. compliance filing no. 99-4005.

Corporate finance witness for the Industrial Customers of Northwest Utilities, docket no. UE 010395, Avista Utilities.

Publication date: 04-Oct-2002
Reprinted from RatingsDirect

# Is State Utility Regulation Coming Back Into Vogue?

Credit Analyst: William Ferara, New York (1) 212-438-7667

Recent inquiries by regulators suggest U.S. state utility commissions are starting to pay more attention to the relationship between a utility holding company's regulated and nonregulated businesses, likely because of problems experienced by certain diversified energy companies. Coupled with vociferous opposition from western and southern states over FERC transmission initiatives, it appears that utility regulation may be moving to the forefront, which could be beneficial for credit quality at the operating company level.

Talk of isolating a utility from the parent company's unregulated activities could be signaling a trend that greater regulation of utilities is back in vogue, which is quite the opposite of one of the reasons--less regulation--why electric restructuring was instituted. Standard & Poor's Ratings Services has long-held a view of a lack of regulatory insulation from nonregulated operations and diminishing regulatory support for utility credit quality, which has caused many ratings downgrades over the past few years. Therefore, any action that state regulators take that provides support (whether legal, regulatory, financial, or operational) to the utility and/or isolates the utility (most importantly financial obligations) from its parent company will be positive for credit.

Although not all regulated utilities have been affected by the troubles at their affiliate companies, in view of the harsh consequences inflicted on utilities in certain cases, Standard & Poor's believes it is quite likely that state regulators will be placing even greater emphasis on "protecting" the utilities they regulate. For instance, in the ongoing probe of Westar Energy Inc, members of the Kansas Corporation Commission are considering some form of break-up of the company's unregulated and utility operations to protect ratepayers. In Minnesota, during hearings to examine the possible spillover of NRG Energy Inc.'s financial problems onto utility ratepayers, state regulators said they are considering drafting measures at establishing a stronger financial barrier between parent company Xcel Energy Inc.'s regulated and unregulated businesses. Both cases represent a desire by state regulators to protect ratepayers by ensuring the utility is run prudently.

Standard & Poor's view of what constitutes sufficient regulatory insulation has evolved given the ongoing business mix shift by utility holding companies toward nonregulated investments throughout the 1990s. Importantly, ratings are based on the qualitative and quantitative fundamentals of the consolidated entity, not just any one individual subsidiary. Thus, credit ratings of regulated utility companies are affected by the parent company's nonregulated businesses. Only when sufficient regulatory insulations exists will the corporate credit rating (risk of default) of an operating company be separated from that of the holding company.

In Standard & Poor's view, insulation brought about by legislative statues is a great deal more certain than state utility commission rulemaking and will ultimately provide for greater ratings separation. Notably, most state regulators maintain their state or

commission has explicit laws or regulations in place that provide sufficient authority to prevent the financial condition of the utility from being adversely affected by the activities of nonregulated affiliates. However, from a credit perspective, Standard & Poor's believes most of these laws and regulations to be reactive measures; they do not prevent the diversified businesses from weakening the regulated business. These rules typically enable state regulators to take action only after the damage has occurred. Examples of active regulation include measures that meaningfully and timely restrict the flow of the utility's cash to its parent company, such as overhead allocation, loan and dividend restrictions, and stringent equity-maintenance requirements.

State utility commissions are also drawing battle lines against the FERC's effort for some standard market design for the nation's transmission infrastructure. In a Standard & Poor's survey, most state regulators, as expected, feel that the states have the proper jurisdiction over retail transmission, and not the FERC, claiming state oversight provides the best way to oversee transmission issues, including transmission siting. The most important issues confronting state regulation of utilities revolve around transmission--reliability and adequacy, siting, and general regulatory issues. The reliability and transmission adequacy problems experienced by California, Massachusetts, and Illinois, all of which were at the forefront of electric deregulation, have made not just regulators, but also politicians and ratepayers, highly sensitized on how to assure electric reliability in a restructured industry.

Although Standard & Poor's views the future rating trend of the electric industry to be decidedly negative, with insufficient regulated authorized returns and expanding nonregulated investments providing the most downward pressure, the credit quality of electric utilities on a stand-alone basis could show signs of stabilization if they are increasingly sheltered by state regulators. Elevated scrutiny of the general well being of a utility company, specifically its exposure within an energy holding company, indicates a gradual return to stronger utility regulation and could calm the deterioration in credit quality experienced in the industry. This attitude from state regulators, which is quite different from their earlier thinking that a parent's nonregulated activities had little or no impact on the utility company, is absolutely more reasonable. Today, the average power industry credit rating is approximately 'BBB+' versus 'A'/'A-' five years ago, with slightly less than one-half of the industry now carrying a 'BBB' category rating.

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Publication date: 06-Sep-2002
Reprinted from RatingsDirect

# Refinancing Risk in the U.S. Power Sector--The Preponderance of "Mini-Perm" Debt

Credit Analyst: Arleen Spangler, New York (1) 212-438-2098

Construction Boom Financed With Short-Term Debt
Were the Original Valuation Assumptions Flawed?
Who's At Risk?

Liquidity has always been important in credit analysis, and has increasingly become a critical component in evaluating the credit quality of the U.S. energy merchant sector. The rapid erosion of many energy merchants' credit quality has been spurred by a lack of adequate liquidity in the face of deteriorating industry fundamentals (in particular, low wholesale energy prices, oversupply of capacity, low demand growth, and low equity valuations).

These weakening fundamentals have resulted in the need for enhanced liquidity to manage through the downward price cycle. Because the energy merchant sector is a relatively new industry paradigm with little historical data, it has yet to be determined just how deep and how long a downward power price cycle may last.

Exacerbating the increased business risk in this sector is the unprecedented level of power plant construction that was financed with short-term construction, or, "mini-perm," financings. The traditional use of long-term project financing for unregulated generation has evolved into short-term mini-perm bank loans of up to five years with expected bond takeouts. The use of this financing technique is driven by the sponsors' desire for the cheapest source of capital and the banks' desire for the shortest loan tenor.

Given the increased business risk, how will the sector successfully refinance about $30 billion to $50 billion of construction or mini-perm financings maturing from 2003 to 2006? Standard & Poor's Ratings Services views the refinancing of mini-perm debt as one of the largest risks facing many of the energy merchants. If weak market conditions continue, the ability to refinance these loans may prove challenging. The mini-perm structure typically protects the banks by incorporating a 100% cash sweep and/or increased pricing to encourage refinancing. Although these structural features may protect lenders, they hamper the sponsor's credit quality by not allowing them access to much needed cash flow from these investments or forcing a refinancing at adverse times.

## Construction Boom Financed With Short-Term Debt

According to RDI Consulting, about 80 gigawatts of electric capacity were completed or in were some form of construction or development in the past three years. This unprecedented level of power plant construction led to overbuilding in most regions of the U.S. 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 is likely occur to the extent necessary to encourage investors to lend eagerly to this sector. With the backdrop of overcapacity, slow demand growth, and about 65% of the generating capacity still in the hands of regulated utilities, the energy merchant sector may experience many years of low wholesale prices. Some industry consultants do not expect a recovery in wholesale prices for several years—perhaps even as far as 2007 or 2008.

Mini-perm financings are typically used as a tool for income-producing projects that need to establish an operating history prior to obtaining long-term permanent financing. The concept is sound in that the banks, which are better able to handle construction risk, finance the construction and early years of a project's operations. Once the project establishes a solid track record, it can typically secure permanent financing. Mini-perms typically have very little principal repayment during their term, but have a large balloon payment at the end of the term.

In the energy merchant sector, many of the mini-perm loans were made at a time when projections for power prices were robust; this led most lenders to assume that refinancing would be easy. The assumption was that after a few years, the project would have an adequate operating history and the ability to secure permanent financing in the capital markets would be straightforward. Furthermore, if refinancing was not successful, the mini-perm structure allowed the banks a 100% cash sweep, higher pricing (higher interest rates), and a security interest in the asset. Assuming the plant was successfully built, the banks argued that refinancing risk was manageable.

There are two problems with this logic. First, the banks assumed that valuations for power plants would remain stable at high enough levels to secure refinancing, and second, that the capital markets would remain open for these types of investments. The valuations used to originally finance these projects may be significantly less with the weakened outlook for power prices. In addition, it has yet to be determined if the capital markets will swallow the long-term risk of merchant power plants. Although there are some fully merchant transactions that were financed in the bond market (e.g., AES Eastern Energy L.P. and Edison Mission Energy (Homer City)), industry fundamentals have changed significantly since those transactions were completed.

Furthermore, as noted, the sheer magnitude of the amounts that require refinancing in the next few years, coupled with current questions about market receptivity, raises serious concerns.

Although the mini-perm structure encourages refinancing with 100% cash sweep mechanisms and increased pricing after a certain date, the estimates for generating cash flow may be revised given a less rosy picture of long-term wholesale power prices. Faced with this bleak outlook, banks may have no choice but to extend maturities to prevent defaults. Standard & Poor's notes that once banks begin to exert control over these assets, sponsors may be faced with weakening financial profiles as many have relied on cash flow from these projects to service corporate debt. If poor market conditions persist or worsen, sponsors may not see a return on these investments for many years to come--or at least until an adequate level of debt is repaid.

## Were the Original Valuation Assumptions Flawed?

During the past 10 years, energy merchants have had unprecedented access to capital. In 2001 alone, there was about $40 billion worth of power financings. These financings were completed based on valuations of power plants that assumed they would contribute positive cash flow after servicing a heavy debt burden. The loans were made when power prices were high and the outlook for the economy was robust. Consultants hired to forecast expected power prices came up with a host of assumptions that appeared reasonable at the time, including rational behavior from market participants, retirements of old, inefficient generating units, and an efficient, fully deregulated power market. Independent power producers, utilities, and regulators throughout the U.S. do not want a repeat of the California power crisis. Thus, they have increased reserve margin requirements, dissuading firms from retiring older, less-efficient plants. They also have postponed or severely delayed any movement toward deregulation. The main assumption used to make many of these loans was a price curve that had increasing power prices, at levels in excess of inflation for the next 20 years. Under this scenario, the projects, even if not able to refinance due to a lack of capital-market access, would be able to repay these loans with cash-sweep mechanisms in six or seven years after the original maturity.

The assumptions used to make many of the mini-perms have been challenged by the recent poor market fundamentals in the power sector. What was once viewed as almost unlimited access to capital has all but dried up for this sector. Many of the banks may not see their loans repaid in the six or seven years, as originally forecast with a cash sweep, but may have to wait many years more for some of these assets to work off the debt load. Furthermore, sponsors will suffer in that they will lose access to the cash flow from these assets. Sponsors may not be able to refinance these assets because of the need for additional equity capital. Equity capital is difficult to come by during times of market distress. This again emphasizes the need for adequate liquidity to be successful in this sector. Some sponsors may be able to draft a reasonably priced long-term contract with a creditworthy counterparty, but it may prove difficult to negotiate a reasonable return during a low price period. Reasonable take-out assumptions based on the current market conditions will drive successful refinancings.

## Who's At Risk?

Most energy merchants that financed construction projects in the recent past will be subject to some refinancing risk (a point already factored into Standard & Poor's ratings of these firms). Whether under the guise of a construction loan or a mini-perm financing, the sector will be challenged in the next several years to find a home for its merchant risk. The bank lenders may be left holding the bag. Standard & Poor's is most concerned with companies that secured many of the "jumbo financings," which are in the billions of dollars for each company. These include GenHoldings I LLC, Teco-Panda, ANP Funding I LLC, NRG Construction Revolver, and Calpine Construction Finance Co.

While financings in the sector have moved away from a piecemeal approach of financing individual assets to diversified portfolio financings--thus mitigating some risk by diversifying across an array of diverse assets--most

energy merchants have not built a true national presence which provides may be uncorrelated. The sector is plagued with financial risks such as inadequate liquidity, severe undercapitalization, and a lack of access to capital, now viewed as a scarce resource, at a time when the ability to refinance may be key to the viability of many of the energy merchants.

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The McGraw-Hill Companies

ARIZONA CORPORATION COMMISSION STAFF'S THIRD SET OF DATA REQUESTS – **Exhibit JST-9**
October 17, 2002
TO ARIZONA PUBLIC SERVICE COMPANY
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

Staff 3-3 (JST)

Page 5: Please provide any studies, correspondence, or other support for the claim that "...PWEC would be unable to raise significant debt financing on a standalone or non-recourse basis."

RESPONSE:

This statement from Mr. Tildesley's testimony is based on Salomon Smith Barney's existing and accumulated knowledge of capital market conditions for merchant generation companies. The testimony is based upon the dearth of financing transactions by non-regulated electric generating companies since the fourth quarter of 2001 due to the lack of investor interest in such companies.

ARIZONA CORPORATION COMMISSION STAFF'S THIRD SET OF DATA REQUESTS
October 17, 2002
TO ARIZONA PUBLIC SERVICE COMPANY
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

**Exhibit JST-10**

Staff 3-4 (JST) Provide all SSB/Citigroup documents concerning APS or its affiliates' debt ratings or equity analyses.

RESPONSE:

Mr. Tildesley's testimony contains qualitative and quantitative analysis supporting the key conclusions of the testimony.

During the past three years, Salomon Smith Barney has not published any credit or equity research reports on Arizona Public Service Company or any of its affiliates.

Staff 3-6 (JST)

Page 11: Provide the analysis referred to in the statement "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." Please indicate how much excess debt capacity APS currently has.

RESPONSE:

Salomon Smith Barney cannot precisely quantify how much excess debt capacity APS currently has (i.e., maximum amount of incremental debt that would allow APS to maintain its current credit rating).

However, Salomon Smith Barney's analysis indicates, as presented in Figure 2 on p. 9 of Mr. Tildesley's testimony, that an incremental borrowing by APS of $500 million would not have a significant impact on its current credit quality. Salomon Smith Barney has not undertaken any analysis of a lesser or greater amount.

**Exhibit JST-12**

Staff 3-5 (JST)

Page 9: Provide the analysis and working papers that support the conclusion 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."

RESPONSE:

The key elements of Salomon Smith Barney's quantitative analysis are presented in Figure 2 on p. 9 of Mr. Tildesley's testimony. Figure 2 contains comparison of APS 2001 credit ratios, actual and pro forma for the proposed $500 million debt issuance or guarantee to PWEC, to S&P's guideline credit ratio ranges.

Attached is DR000174, a worksheet for the computation of the credit ratios for APS, based on the data in the APS annual report for 2001.

Exhibit JST-13

Attachment
Worksheet for Computation of Credit Ratios

## Impact on APS

| ($ in millions) | LTM (a) | $500mm Intercompany Debt Adjustments (b) | $500mm Intercompany Debt Pro Forma | $500mm Guarantee Adjustments (c) | $500mm Guarantee Pro Forma |
|---|---|---|---|---|---|
| EBIT, as reported | $528 | | $528 | | $528 |
| Add back: Implicit interest expense, Palo Verde lease (d) | 26 | | 26 | | 26 |
| EBIT, adjusted for lease | 554 | | 554 | | 554 |
| Interest expense, as reported, excluding capitalized interest | $118 | $27 | $145 | $27 | $145 |
| Add: Implicit interest expense, Palo Verde lease (d) | 26 | | 26 | | 26 |
| Interest expense excl. capitalized interest, adjusted for lease | 144 | | 171 | | 171 |
| Gross interest expense, as reported, including capitalized interest | $133 | $27 | $160 | $27 | $160 |
| Add: Implicit interest expense, Palo Verde lease (d) | 26 | | 26 | | 26 |
| Gross interest expense incl. capitalized interest, adjusted for lease | 160 | | 186 | | 186 |
| Funds flow from operations (FFO), as reported | $494 | $7 | $501 | ($16) | $477 |
| Total debt, as reported | $2,398 | $500 | $2,898 | $500 | $2,898 |
| Add: Net present value of Palo Verde lease payments (e) | 464 | | 464 | | 464 |
| Total debt, adjusted for lease | $2,862 | | 3,362 | | 3,362 |
| Common equity | 2,190 | | 2,190 | | 2,190 |
| Total capitalization, as reported | 4,589 | | 5,089 | | 5,089 |
| Total capitalization, adjusted for lease | 5,053 | | 5,553 | | 5,553 |
| **Credit Ratios:** | | | | | |
| FFO Interest Coverage (f) | 4.0x | | 3.6x | | 3.5x |
| FFO / Debt (g) | 17.2% | | 14.9% | | 14.2% |
| Debt / Book Capitalization (h) | 56.6 | | 60.6 | | 60.6 |
| EBIT / Interest (i) | 3.5x | | 3.0x | | 3.0x |

**Notes:**

Assumes tax rate of 39.0% and interest rate of 5.32% (calculated based on 10 Year Treasury, as of 10/ 7/ 02 plus assumed 1.70 spread) for APS debt and guarantee, and 7.75% interest rate for intercompany debt

(a) LTM, as of June 30, 2002, from public Company filings
(b) Assumes that money is borrowed by APS at 5.32% interest rate, and lent on to PWEC at 7.75% interest rate
(c) Assumes that money is borrowed by PWEC at 5.32% interest rate, and that APS interest expense, FFO, EBIT and debt is adjusted
(d) Implicit interest expense of Palo Verde lease, using 5.70% interest rate, and calculated based on net present value of future Palo Verde lease payments
(e) NPV of Palo Verde operating lease payments, using 5.70% interest rate
(f) = (FFO + Adjusted interest expense excl. capitalized interest) / (Adjusted gross interest expense incl. capitalized interest)
(g) = FFO / Adjusted total debt
(h) = Adjusted total debt / Adjusted total capitalization
(i) = Adjusted EBIT / Adjusted gross interest expense incl. capitalized interest

EXHIBIT
S-2
admitted

Moody's Investors Service

Global Credit Research
Liquidity Risk Assessment
31 DEC 2002

**Liquidity Risk Assessment:** Pinnacle West Capital Corporation

**Pinnacle West Capital Corporation**

*United States*

| | |
|---|---|
| **Broad Industry:** | Public Utility |
| **Specific Industry:** | Electric Holding Co. |
| **Short Term Rating:** | P-2 |

**Contacts**


| **Analyst** | **Phone** |
|---|---|
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| Daniel Gates/New York | |


**Opinion**

Pinnacle West Capital Corporation's (PWCC) short-term rating for commercial paper of Prime-2 reflects predictable subsidiary cash flows, the growing service territory of Arizona Public Service Company (APS: Senior Unsecured Baa1), and a moderate dividend payout ratio. The rating also considers PWCC's business strategy, which largely centers around providing traditional electric service to the western US, with a particular emphasis on the Arizona market. Consolidated funds from operations interest coverage for PWCC is expected to be over 3.5x over the next several years, while PNW's consolidated leverage, although increasing modestly, is expected to average around 55% in this time frame.

Borrowings under the commercial paper program are used for working capital needs at PWCC, and to fund capital requirements for Pinnacle West Energy Corporation (PWEC), a generation company subsidiary. PWCC's cash flow relies upon dividends paid by its operating subsidiaries, including APS.

PWCC faces refinancing risk during 2003. In light of the Arizona Corporation Commission's (ACC) decision to change the rules around electric restructuring, generating assets that were intended to be transferred from APS to PWEC will not be transferred. Therefore, a PWEC financing that was intended to repay holding company debt will be difficult to complete. PWCC has addressed this issue by filing with the ACC a request for approval to have APS borrow up to $500 million at the utility and lend the proceeds to PWEC.

On December 13, 2002, the ACC staff recommended approval of the APS financing application including the ability of APS to lend PWEC up to $500 million under predefined terms. These terms include, among other things, that the loan be secured by PWEC assets, that PWEC pay APS a premium interest rate on the amount advanced, and that APS maintain a common equity ratio of at least 40%. Also, on December 13, 2002, the ACC staff and APS agreed in a separate document that it would be appropriate for the ACC to consider in APS' upcoming general rate case whether certain power plants currently owned by PWEC should be included in APS' rate base.

Additionally, on December 23, 2002, PWCC raised approximately $200 million in net proceeds from the sale of common stock. The proceeds were used for debt reduction at PWCC.

Liquidity support for the Prime-2 commercial paper program is provided by revolving credit facilities available to PWCC, that expire in July 2003 and November 2004. The credit facilities have a MAC clause for new money borrowings, and have debt to capitalization and cash interest coverage financial covenants that appear to provide significant room. No rating triggers exist in any PWCC credit facilities.

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S-4
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# Research:

## Arizona Public Service Co.'s Corporate Credit Rating Lowered; Parent Pinnacle Affirmed

**Publication date:** 04-Nov-2002
**Credit Analyst:** Kathryn Mock Masterson, San Francisco (1) 415-371-5009

NEW YORK (Standard & Poor's) Nov. 4, 2002--Standard & Poor's Ratings Services said today it affirmed the debt securities ratings of electric utility Arizona Public Service Co. (APS) and lowered the corporate credit rating (CCR) to triple-'B' from triple-'B'-plus. At the same time, it affirmed the triple-'B' corporate credit rating of parent Pinnacle West Capital Corp. (PWCC), and lowered its triple-'B' senior unsecured debt rating to triple-'B'-minus.

The downgrade of the APS CCR is the result of Standard and Poor's conclusion that the regulatory insulation standard is insufficient to warrant a separation of the CCRs between APS and PWCC. The triple-'B' CCR at both entities reflects the consolidated rating of the combined entity.

"This action also results in a change in the unsecured debt rating at PWCC because of the structural subordination of this debt as compared to the unsecured debt at APS since the two are viewed as a single economic entity," said Standard & Poor's credit analyst Kathryn Mock Masterson.

The senior secured rating of APS was affirmed at senior secured 'A-' due to substantial overcollateralization of the first mortgage bonds and, importantly, management's stated intent not to issue significant additional secured debt. All first mortgage bonds are callable as of March 2004, which will allow APS to retire its old 1946 master first mortgage bond indenture.

It is important to note that these rating actions are not a result of the company's proposal to move $500 million of debt from PWCC to APS. Based on Standard & Poor's consolidated rating methodology, the movement of debt from the parent to the subsidiary does not affect the overall financial health of the entities. Even on a stand-alone basis, APS' financial health remains solidly within the triple-'B' category even with the addition of $500 million in debt.

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www2.standardandpoors.com: under Fixed Income in the left navigation bar, select Credit Ratings Actions.

10/11 Memo

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# Arizona Public Service Corporate Credit Rating Lowered to 'BBB'

**Publication date:** 04-Nov-2002

**Analyst(s):** Kathryn Mock Masterson, San Francisco (1) 415-371-5009

**Credit Rating:** BBB/Stable/A-2

## Rationale

On Nov. 4, 2002, Standard & Poor's Ratings Services affirmed its debt securities ratings of electric utility Arizona Public Service Co. (APS) and lowered the corporate credit rating (CCR) to 'BBB' from 'BBB+'. At the same time, it affirmed the 'BBB' corporate credit rating of Pinnacle West Capital Corp. (PWCC), and lowered its 'BBB' senior unsecured debt rating to 'BBB-'.

The downgrade of the APS CCR is the result of Standard and Poor's conclusion that the regulatory insulation standard is insufficient to warrant a separation of the CCRs between APS and PWCC. The 'BBB' CCR at both entities reflects the consolidated rating of the combined entity.

This action also results in a change in the unsecured debt rating at PWCC because of the structural subordination of this debt as compared to the unsecured debt at APS since the two are viewed as a single economic entity.

The senior secured rating of APS was affirmed at 'A-' due to substantial overcollateralization of the first mortgage bonds and, importantly, management's stated intent not to issue significant

additional secured debt. All first mortgage bonds are callable as of March 2004, which will allow APS to retire its old 1946 master first mortgage bond indenture.

It is important to note that these rating actions are not a result of the company's proposal to move $500 million of debt from PWCC to APS. Based on Standard & Poor's consolidated rating methodology, the movement of debt from the parent to the subsidiary does not affect the overall financial health of the entities. Even on a stand-alone basis, APS' financial health remains solidly within the 'BBB' category even with the addition of $500 million in debt.

The ratings reflect the following credit strengths of the consolidated entity:

-- Continued ownership of a diverse generation portfolio by APS, which allows the utility to operate as a vertically integrated utility and to recover costs associated with load resource planning. However, the operational risk associated with the retention of generating assets nullifies the anticipated strengthening of APS' business profile;

-- The expectation that, although APS will still be required by the ACC, to competitively bid for the portion of its summer peak load that cannot be supplied through current APS assets, the utility will receive regulatory cost recovery for this purchased-power amount; and

-- Strong dividends projected from the SunCor subsidiary in the next few years that will be used to reduce the bridge financing debt at PWCC.

The ratings also reflect the following credit concerns:

-- About $550 million in debt matures at PWCC in mid-2003, which places some liquidity pressure on the consolidated entity. Available borrowing capacity under the PWCC bank lines is about $265 million as of Sept. 30, 2002, although this is expected to decline significantly by July 2003 as the $300 million bank line is used to finance additional plant expansion at one of PWCC's subsidiaries, Pinnacle West Energy Corp. (PWEC);

-- Uncertainty regarding future revenues from PWEC given the ACC's decision to halt the transfer of 4,000 MW in generation assets from APS to PWEC and a requirement that APS bid for the amount of energy not supplied by its own assets. In 2003, PWEC assets will operate as merchant plants and will not have any competitive advantage when competing to serve APS load;

-- Increasing amount of consolidated operations coming from unregulated businesses. In 2003, unregulated businesses--principally PWEC and SunCor--are expected to account for 15% of funds from operation; and

-- Power cost exposure at APS given the rate freeze that is in place until 2004 and the lack of a power cost adjustment mechanism.

The consolidated financial profile is adequate for current ratings. Cash flow coverage of interest looks strong, however, the capital structure, including the Palo Verde operating lease, is weak when compared with the 'BBB' rating benchmarks. This is projected to improve once capital spending at PWEC decreases (in late 2003) and

capital spending is, once again, concentrated in the regulated rate base of APS needed to satisfy the continued strong growth of the customer base.

*Liquidity*

Liquidity is adequate, but will fall to slim levels in mid-2003 when the $550 million comes due. The company intends to redeem this debt with the $500 million issue at APS, which will be loaned to PWEC to repay most of the financing. Dividends from APS and SunCor in 2003 and 2004 are expected to be sufficient to repay the remaining amounts. The current ratings reflect the assumption that this repayment will occur and that the $500 million will be issued at APS.

## Outlook

The stable outlook reflects the assumption that the ACC will approve the application by PWCC to issue up to $500 million at APS to repay a portion of the $750 million bridge financing at PWCC that was done to build assets at PWEC, as required by the 1999 settlement agreement with the ACC. The addition of two members to the ACC in November 2002 is not expected to have a material change in the support the ACC has recently indicated toward APS' proposal. The issuance at APS should relieve liquidity pressure at PWCC.

Ratings List

Ratings Affirmed

| | |
|---|---|
| **Pinnacle West Capital Corp.** | |
| Corporate credit rating | BBB/Stable/A-2 |
| Commercial paper | A-2 |
| **Arizona Public Service Co.** | |
| Senior secured debt | A- |
| Senior unsecured debt | BBB |
| Secured lease obligation bonds | BBB |
| Commercial paper | A-2 |

Ratings Lowered

| | To | From |
|---|---|---|
| **Arizona Public Service Co.** | | |
| Corporate credit rating | BBB/Stable/A-2 | BBB+/Stable/A-2 |
| **Pinnacle West Capital Corp.** | | |
| Senior unsecured debt | BBB- | BBB |

Complete ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www2.standardandpoors.com; under Fixed Income in the left navigation

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# Sempra / SWPGII

# 1

Newsroom
News Releases

EXHIBIT
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Admitted

**September 29, 1999**

## Pinnacle West to Build Large Power Project in Western Maricopa County

PHOENIX Pinnacle West Capital Corporation (NYSE:PNW) plans to develop a natural gas-fired electric generating station of up to 2,120 megawatts approximately 50 miles west of Phoenix near the Palo Verde Nuclear Generating Station switchyard, Generation President Bill Stewart announced today.

The plant will compete in deregulated energy markets of Arizona, California and other western states and will be operated by Pinnacle West Energy, the new Pinnacle West generating entity that was formed earlier this week.

"We intend to be a vigorous player in these competitive generation markets," Stewart said. "We have a strong record of low-cost, efficient plant operation. We can best serve the public and our shareholders by pursuing these developing markets, particularly in Arizona and the Southwest."

The state-of-the-art, four-unit combined cycle plant will be built in phases, coming on line in 530-megawatt increments beginning in 2003, with the final unit anticipated to be operational in 2007. Land has been acquired and environmental permit applications are being prepared and submitted for the project. Construction contracts will be on a fixed-price basis and total approximately $1 billion. Work on the first unit is expected to begin in late 2000.

As part of the project, Pinnacle West has begun seeking the input of residents from nearby neighborhoods and communities who will be asked to provide advice during planning, construction and operation of the new facility.

The plant's location was selected because the Palo Verde switchyard is a major transmission hub and provides access to energy markets in Arizona, California and across the Southwest, a region that has seen significant growth. Since 1994, electricity usage in Arizona has increased more than 4.5 percent a year.

In a separate project announced in April, Pinnacle West and Calpine Corp. of San Jose, Calif., will build a 530-megawatt natural gas-fired combined cycle unit at the existing West Phoenix Power Station. Pinnacle West also will build a 130-megawatt combined cycle unit at West Phoenix. Environmental permit applications are being prepared and submitted, and construction of the smaller unit is to begin early next year.

Natural gas-fired, combined cycle technology is widely regarded as clean burning because it first uses hot combustion gases to power one turbine and then uses the same gases a second time to produce steam that can power a second turbine, essentially using the same heat energy twice. Combined cycle technology produces the lowest emissions of any fossil fuel.

Long term, the Pinnacle West projects will provide electricity to sustain a strong economy, Stewart said. In addition, they will make available low-cost power for consumers during periods of high demand, such as during hot summer months, as well as stabilize the southwestern power grid to prevent imbalances that can cause power interruptions.

Pinnacle West, through its subsidiary APS, manages approximately 8,000 megawatts of generating capacity.

## Contacts

*This press release contains forward-looking statements that involve risks and uncertainties, which include, but are not limited to, the ongoing restructuring of the electric industry; the outcome of the regulatory proceedings relating to the restructuring; regional economic and market conditions, which could affect customer growth and the cost of power supplies; the cost of debt and equity capital; weather variations affecting customer usage; and the strength of the real estate market. These factors and the other matters discussed above may cause future results to differ materially from historical results, or from results or outcomes currently expected or sought by the Company.*

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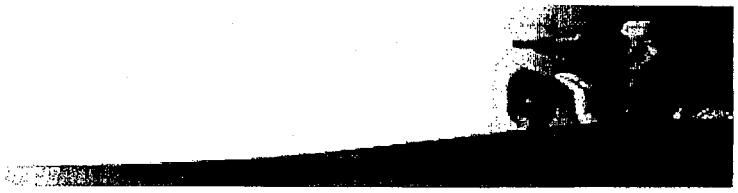

**December 4, 2000**

## A Pinnacle West Energy Announces Generation Expansion Milestones

PHOENIX – Pinnacle West Energy, the generation subsidiary of Pinnacle West Capital Corporation (NYSE: PNW), today announced the beginning of construction of the Redhawk Power Plant, the largest of the projects among the company's current generation expansion activities. The Dec. 19 groundbreaking marks just one of three important milestones for the company's expansion program.

The 2,120-megawatt Redhawk Power Plant, located near the Palo Verde Nuclear Generating Station 55 miles west of Phoenix, will be the first project to actually break ground in the Palo Verde area.

"This is a major accomplishment for us, as well as for customers throughout Arizona and the West," said Bill Stewart, President of Pinnacle West Energy. "This project, along with others we have announced, will allow us to help meet increasing demands for power in Arizona and markets across the Southwest and at the same time promote a competitive market that will ultimately benefit customers. We intend to offer competitively priced electricity in these markets by producing reliable, low-cost power that is accessible to key transmission hubs."

The first two units of the four-unit combined cycle Redhawk project are scheduled to begin commercial operation in the summer of 2002.

Pinnacle West Energy's other new generation projects – the second milestone – are on track as well. In July, the company began building the first of two new units at the West Phoenix Power Plant. The first unit, a 120-megawatt combined cycle unit, is expected to be complete by the summer of 2001, with the larger, 530-megawatt combined cycle unit scheduled for completion by the summer of 2003.

The third milestone involves today's announcement that the company is purchasing the 72-megawatt Harry Allen power station in southern Nevada, adding a strategic link to its efforts to expand generating capacity in the West. As demand grows in the region, the company expects to add a 500-megawatt natural gas-fired, combined cycle unit to the site.

"This is a very important step in our overall growth strategy to remain one of the top power producers in the West," Stewart said. "There are tremendous opportunities to expand the capacity at this site, and it's ideally situated to help meet the increasing demand throughout the Southwest. In southern Nevada alone, particularly Las Vegas, electricity needs are growing four times faster than the national average."

Pinnacle West Energy is purchasing the station, located about 30 miles northeast of Las Vegas, from Nevada Power Company through a public, sealed-bid auction process. The net purchase price, after adjustments for purchased power commitments, is $65.2 million. The power generated at Harry Allen will be sold under contract to Nevada Power, a subsidiary of Sierra Pacific Resources (NYSE: SPR), until March 2003. The purchase is expected to be complete in mid-2001.

The Nevada project demonstrates the company's intention to expand its generating capabilities outside of Arizona and New Mexico. Along with Pinnacle West Energy's other new power plants in development, this brings the company's expansion plans to about 4,000 megawatts – or enough to meet the electricity needs of about 1,000,000 homes in the Southwest.

Pinnacle West Capital Corporation is a Phoenix-based company with consolidated assets of approximately $7 billion. Through its subsidiaries, the company generates, sells and delivers electricity and sells energy-related products and services to retail and wholesale customers in the western United States. It also develops residential, commercial and industrial real estate projects.

Headquartered in Nevada, Sierra Pacific Resources is a holding company whose principal subsidiaries are Nevada Power Company, the electric utility for southern Nevada; Sierra Pacific Power Company, the electric utility for most of northern Nevada and the Lake Tahoe area of California; and a natural gas and water distributor in the Reno-Sparks area. Other subsidiaries include the Tuscarora Gas Pipeline Company, which owns 50 percent interest in an interstate natural gas transmission partnership; and Sierra Pacific Communications, a telecommunications company.

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**January 10, 2001**

## Pinnacle West Energy Awaiting Approval on Acquisition of Nuclear Assets, Focusing on New Generation Projects

PHOENIX - Pinnacle West Energy announced today that it will not match a higher bid to complete the purchase of Southern California Edison's portion of the Four Corners Power Station. In a related transaction for the purchase of SCE's share of the Palo Verde Nuclear Generating Station, Pinnacle West Energy stated that approval of its $250-million contract is still pending before the California Public Utilities Commission.

Pinnacle West Energy's plan to substantially increase its generation portfolio remains on track. Construction has begun on Redhawk 1 and 2, a matching pair of 530-megawatt combined cycle plants near the Palo Verde switchyard. In addition, West Phoenix 4, a new 120-megawatt combined cycle unit is scheduled to begin providing power to customers by June, and construction on West Phoenix 5, a 530-megawatt combined cycle unit, is scheduled to begin this year with operation planned for the summer of 2003.

"Our strategy, which focuses on generation growth opportunities in the western United States, is based on long-term market fundamentals and is financially disciplined," said Bill Stewart, president of Pinnacle West Energy.

Stewart also pointed out Pinnacle West Energy's recent purchase of the Harry Allen site in southern Nevada, a gas-fired facility that currently can produce 72 megawatts with the capability to be increased by another 500 megawatts over the next five years.

Last April, the company announced it had entered into two agreements to acquire approximately 1,300 megawatts of electrical generation at Palo Verde and Four Corners from SCE for a total price of $550 million. SCE owns 48 percent of Four Corners Units 4 and 5 – 740 megawatts each – and 16 percent of Palo Verde, a three-unit, 3,900-megawatt site. APS, a Pinnacle West Energy affiliate, is part owner and operator of both plants.

Pinnacle West Energy is the wholesale generating subsidiary of Pinnacle West Capital Corporation (NYSE: PNW), a Phoenix-based company with consolidated assets of approximately $7 billion. Through its subsidiaries, the company generates, sells and delivers electricity and sells energy-related products and services to retail and wholesale customers in the western United States. It also develops residential, commercial and industrial real estate projects.

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