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; 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

Panda Gila River, L.P. ("Panda") hereby provides notice of filing the Direct Testimony of Susan Abbott, as required by the Commission's procedural order in the above-captioned matter, dated October 9, 2002.

RESPECTFULLY SUBMITTED this 13th day of December, 2002

By [signature]

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DIRECT TESTIMONY OF
SUSAN D. ABBOTT

ON BEHALF OF
PANDA GILA RIVER, LP

DECEMBER 13, 2002

TABLE OF CONTENTS

I. INTRODUCTION

Q. Please state your name, by whom you are employed, and your business address.

A. My name is Susan Abbott. I am currently an independent consultant to the power industry specializing in credit and credit rating issues. My business address is 143 Imperial Avenue, Westport, Connecticut 06880.

Q. Please summarize your academic and business experiences.

A. I received a BA in literature from Syracuse University in 1973, and an MBA from the University of Connecticut in 1981. I worked for 5 years for Aetna Life and Casualty doing private placement investing, primarily in the electric utility industry. For 20 years I worked for Moody's Investors Service ("Moody's") in various capacities, including 3 years as a senior analyst in the Electric Utility Group, and 10 years as Managing Director of the Power Group. For 18 of my 25 professional years, I have followed the electric sector either as a lender to, or a rater of electric utility companies.

Q. What is the purpose of your testimony?

A. I have been retained by Panda Gila River, an intervenor in this proceeding, to evaluate Arizona Public Service Company's ("APS") proposal to refinance $500 million in debt currently residing at Pinnacle West Capital Corporation ("PWCC") or, alternatively, for APS to corporately guarantee the same amount of debt refinanced at

PWCC, in light of the effect of such actions on Arizona ratepayers and wholesale competition.

Q. Why is the refinancing proposal important to Panda Gila River?

A. Panda Gila River is concerned that the requested financing could detrimentally impact wholesale competition in Arizona and, undermine the Commission's goal of allowing Arizona ratepayers to secure electric supplies at the least available cost. As I explain below, if approved, the proposal has the very real likelihood of resulting in a credit downgrade for APS. A credit downgrade would harm ratepayers insofar as they ultimately would be responsible for the higher financing costs that follow from such downgrades. A downgrade, in decreasing APS' credit standing, also would increase APS' cost of doing business (and therefore its ratepayer costs) in any transaction arising out of the Commission's mandated solicitation process. And if the loan were collateralized by the PWEC assets, and the assets did not fair well in the solicitation and succeed in capturing load, APS ratepayers would be saddled with additional costs associated with a further deterioration in APS' credit as APS became increasingly responsible (because cash flowing from PWEC was diminished or absent altogether) for paying interest and principal on the loan from its own cash flow.

More fundamentally, though, as I describe below, were the loan to be approved, APS would immediately come under pressure to seek to rate base the PWEC assets in order to shore up its financial condition. Fitch Ratings has already begun this push by its assertion that the "incremental debt [i.e., the $500 million] would be less problematic if it ultimately becomes part of the cost of transferring and rate-basing PWEC's generation at APS." See, Fitch Ratings December 4, 2002, available at http://www.reuters.com/newsArticle.jhtml?type=topNews&storyID=1852399. The likelihood of such an outcome increases if the inter-company loan were collateralized by the PWEC assets and the assets do not fair well in the solicitation and capture load so as to generate cash flow. Then, as the only cash available to pay the loan is dividends from APS to PWCC, the loan may be defaulted on, giving ownership of the PWEC assets to APS. Any effort to rate base the affected PWEC assets not only would directly affect ratepayers (by virtue of their having to bear all the costs of such assets going forward) but also would diminish the opportunity for ratepayers to receive the benefits of the lowest cost generation available, as mandated by the Commission's prior orders mandating wholesale competition.

Q. Please summarize your testimony?

A. I analyzed the proposed transaction from a number of perspectives. First, I looked at the options PWCC has to refinance the debt. Based on APS discovery answers, it does not appear that PWEC made any efforts to finance the debt at the PWEC level. While it is a difficult time to finance in the merchant industry, funds are available, at a price. Assuming however that PWEC could not finance the debt itself, I conclude that PWCC is the most appropriate source of financing as PWCC benefits from the PWEC assets while APS does not. Likewise, refinancing through APS exposes APS, and ultimately its ratepayers, to unreasonable risk with regard to default. Finally, financing the debt at APS transforms its option to pay dividends to PWCC into a fixed obligation in the form of interest payments, which are not optional.

Second, I looked at the expected financial market response to the refinancing if it were at the APS level versus at the PWCC level. I conclude that the proposed loan or guarantee would harm APS, a regulated utility, and its ratepayers by adversely affecting APS' rating by credit rating agencies. Indeed, contrary to APS's assertions, the financial community likely would view a loan directly to PWCC as a reasonable investment. Further, it is my opinion that the Commission's order staying divestiture, Decision No. 65154, actually improved the overall business risk profile of PWCC by reducing the amount of merchant risk from approximately 6000 MW to around 1700 MW.

II. OVERVIEW OF CREDIT ANALYSIS AND RATING METHODOLOGY

Q. Do credit professionals treat refinancing and guarantees differently?

A. No. Either one would be considered a new debt obligation at APS by the rating agencies and the financial community. A direct loan is obviously considered an obligation of the company borrowing the money. In the case of a guarantee, the financial community assumes for purposes of calculating financial leverage (or the level of total debt in relation to total capitalization) that the guarantee will be called upon at some time. Therefore, a guarantee is a real and present obligation of the company offering the guarantee and is treated no differently than a direct debt obligation.

Q. In your opinion, what choices does PWCC have to refinance this debt?

A. Ideally, Pinnacle West Energy Corporation (PWEC) would refinance the existing debt using its merchant generation assets as security. Given the conditions in today's market, however, it is doubtful PWEC would be able to obtain such financing under commercially attractive terms, although I have not seen any evidence of efforts made by PWEC to finance the debt directly or the terms offered. However, it appears that no efforts have ever been made to finance PWEC assets through PWEC.

In fact, in answer to question 18e of Panda's First Set of Data Requests, APS states that "PWEC did not seek to obtain project specific or other financing to finance the PWEC assets after preliminary discussions with lenders showed that such financing was not a cost-effective option." Ms. Gomez testified on October 11, 2002 that "project financing may have been available to PWEC . . . but such financing would have been more expensive than waiting until the end of 2002 and using PWEC's investment grade rating to secure non-project financing" indicating that no such attempt has ever been made, even though it was believed that financing was available.

It is important to point out that funds are available at a price. Many power industry borrowers have recently been forced to borrow at what at one time would have been considered unattractive terms. See, for example, the article from the Wall Street Journal titled "Energy's Industry's debt Is Long-term Problem," attached to the Staff Memorandum in response to APS's Emergency Application (Docket No. E-01345A-02-0840). The article quoted an S & P analyst as stating "companies can expect to pay higher interest rates and put up hard assets such as plants and pipelines as security to get new financing . . ..”

If financing is unavailable, PWEC should turn most appropriately to PWCC as a potential source of refinancing. The original bridge financing, with PWCC financing the PWEC assets, was not out of the ordinary. PWCC financing the PWEC assets was not the only choice available to PWEC, and, in my experience, it is not the most popular choice for owners of substantial megawatts. While a holding company just getting started in the unregulated power field may finance, at the holding company level, its first few hundred megawatts, many holding companies owning substantial megawatts project finance them, specifically to shield the parent company and other affiliated companies from troubles that might arise at the unregulated power company subsidiary.

Q. Are you concerned that 1700 MW would not give PWEC a “national presence?”

A. No. Although Ms. Gomez states in her testimony of October 11, 2002 that she is concerned that PWEC would “have no national presence” without the APS assets, neither financing nor successful competition in the electricity markets depends on a “national presence.” The power industry is a regional or local business and a generating asset succeeds or fails in the long-run according to its economics relative to the regional or local market in which it operates.

A number of limited capacity generating companies have been project financed. Many of those have long-term contracts on which the financing and a credit rating were based. There are notable exceptions to this generalization, including AES Eastern Energy (1,268 MW, "Ba1" original rating, 100% merchant), and PPL Montana (1,260 MW, "Baa3" original rating, 100% merchant). Both of these are a local or regional operation, and the original ratings resulted from the competitive economics of the projects relative to regional competition. Ms. Gomez states that PWEC would be a "strong and viable competitor . . . in . . . Arizona," putting it in the same category as others that were successfully project financed. PWEC had the opportunity to project finance its assets when such monies were readily available, probably as late as the 3rd quarter of 2001. Changing project financing circumstances do not make a rescue of PWEC by APS any more appropriate than it would have otherwise been.

Q. If the debt truly cannot be financed at PWEC, which entity, PWCC or APS, is the more appropriate to refinance this debt?

A. Generally, PWCC is the appropriate source of refinancing since the proceeds were used to build PWEC's 1,700 MW of merchant capacity. APS does not benefit from PWEC owning those megawatts.

Importantly, if APS finances assets that belong to PWEC or PWCC, APS is exposed to a high degree of risk should the affiliate default. For example, lenders to PWCC will attempt to reach into APS to recover loans made to PWCC. This is a very real factor in a credit rating analysis. The closer the affiliates are tied to each other through inter-company financial dealings and shared boards of directors and management, the more concern the financial market has that investors will be successful in reaching ay one affiliate's assets.

Q. How is this concern expressed by the financial markets?

A. Standard & Poor's recent downgrade of APS' corporate credit rating to "BBB" from "BBB+" reflects this very concern. They stated that the lack of sufficient regulatory insulation of APS from PWCC and PWEC weakens any separation APS has from the parent and its unregulated affiliates. Inter-company financial dealings, such as APS refinancing or guaranteeing the $500 million, or the recent $125,000,000 inter-company loan only supports S & P's point.

Q. In light of your comments, why would APS seek to finance the PWEC debt?

A. I'm not sure I can answer that from APS's perspective but I can explain why APS financing the PWEC debt might make sense for PWCC and its shareholders. From a practical standpoint, many investors are backing away from the merchant energy sector as a result of depressed energy prices, the large amounts of debt being carried by some companies, and the current lack of trust that exists as a result of certain accounting and other scandals. Therefore, there is a chance that investors could refuse to lend to PWCC to refinance the PWEC assets or would only do so at a premium. It is perfectly understandable why PWCC has resorted to requesting permission to refinance PWEC debt at APS since APS, as a regulated, vertically integrated utility has a better chance than its unregulated affiliates of financing on attractive commercial terms.

Q. Does that factor make it appropriate for the loan to come from APS?

A. Absolutely not. In fact, just the opposite is true. There simply is no benefit to APS's ratepayers in allowing APS to take on the burden of PWEC related debt just because conditions in the financial markets have changed and APS may be able to get a better deal than PWEC or PWCC.

Q. Since debt service on the PWCC debt would be paid mostly through dividends from APS, why does it matter whether the debt is guaranteed by or refinanced by APS?

A. To clarify, there are two possible scenarios. The first scenario has the $500 million in debt remaining at PWCC or PWEC. Under this scenario, debt service is ultimately paid through dividends paid by APS. The second scenario has the $500 million refinanced or guaranteed by APS. Under this scenario, debt service is a fixed obligation of APS. From a corporate finance perspective, the payment of dividends is an "option." A company can pay them or not, depending on circumstances at that moment in time. This is not the case with fixed obligations such as the proposed debt. Thus, dividends allow a company the financial flexibility to stop payment and divert funds to more pressing needs as necessary. By refinancing or guaranteeing the $500 million, APS transforms the "option" associated with a dividend into a fixed obligation. This materially diminishes APS' ability to handle unexpected circumstances going forward.

In addition, APS' promise that none of the costs associated with refinancing the debt at APS would be passed on to ratepayers means, to the financial community, that APS will be absorbing costs that it will not be allowed to recover through the ratemaking process. This in itself diminishes creditworthiness because cash flow levels remain the same while obligations on debt increase. Therefore the cushion for unexpected events becomes less, making APS more vulnerable to circumstances beyond their control. The attempt by APS to have the commission declare the proposed debt something other than continuing debt further exacerbates the potential diminution in APS' ability to handle unforeseen financial events. Calling the proposed $500 million financing something other than continuing debt allows APS additional leeway under the rules to take on even more debt. The financial community doesn't distinguish between "continuing" or any other kind of debt, but does pay attention to restrictions on amounts of debt allowed by regulators, bank lenders and bond indentures. These restrictions are important. But if APS is given additional leeway to incur even more debt, the financial community will become alarmed.

Q. What, in your estimation, would be the market response to a refinancing at APS versus at PWCC?

A. It is true that lenders and bondholders would likely believe that an investment in APS is more secure than an investment in PWCC because of (i) the regulated, and therefore more predictable, nature of APS and (ii) the unregulated, less predictable nature of PWCC. At the same time, however, a new financing at APS would diminish APS' credit quality overall because of the additional debt obligation it will have without corresponding additional cash flow. Therefore, lenders would charge APS more for debt than previously charged. In addition, any future APS debt would cost more for APS to issue than in the past.

Alternatively, if the banks lent directly to PWCC, lenders would get paid more than if they lent to APS directly to compensate for the additional risk. However, lenders would have somewhat less security because the cash flow to repay the debt is one step removed from PWCC since it comes from dividends paid by APS. Remember, APS has the option to stop payment of dividends. If banks lent directly to PWCC and APS did not guarantee/refinance the additional $500 million in debt, APS would likely remain a strong company with a low risk business profile. Dividends will likely continue flowing to PWCC.

Ultimately, investors make investment decisions according to each lender's portfolio needs. On balance, a refinancing at PWCC could be viewed as a reasonable investment with a higher interest rate, but not a lot of additional risk, compared to a loan to the regulated utility to support its affiliate.

Q. As a credit professional, how would you assess PWCC and APS if APS' request to refinance or guarantee $500 million of PWCC debt at the APS level were granted?

A. I would first analyze the effect of granting the APS request (i.e. how would a $500 million loan or loan guarantee affect APS' rating with the rating agencies?). Second, I would analyze the effect of denying APS' request (i.e., what would happen if the debt couldn't be refinanced at the PWCC level, and the potential effect on APS if, in the worst case, PWCC collapsed?). My conclusion would be drawn from these impacts and the likelihood of each scenario.

Q. Can you describe the different ratings approach taken by Moody's and S & P regarding their respective ratings on PWCC and APS?

A. Yes. Moody's, Fitch and S & P take two very different approaches to rating power companies. Moody's and Fitch follow similar methodologies, while S & P has its own unique approach. Let me briefly explain each. The chart below lists the rating categories used by Moody's and S & P to express opinions of creditworthiness (from highest to lowest). Fitch and S & P use the same rating symbols, but Fitch rates PWCC and APS at the same levels as Moody's. To the right of the rating symbols is a brief description of what each symbol indicates about a company's creditworthiness. Following the chart is an explanation of how the two different approaches used by S & P and Moody's and Fitch result in rating symbols within a corporate family to express opinions about the creditworthiness of each member of the family. From now on in my testimony, Moody's and Fitch's approach will be

Summary of Rating Agency Categories

Category	S&P	Moody's	General Description
Investment Grade	AAA	Aaa	Extremely strong capacity to meet financial commitments
	AAA-	Aaa	Extremely strong capacity to meet financial commitments
	AA+	Aa1	Very strong capacity to meet financial commitments
	AA	Aa2	Very strong capacity to meet financial commitments
	AA-	Aa3	Very strong capacity to meet financial commitments
	A+	A1	Strong capacity to meet financial commitments
	A	A2	Strong capacity to meet financial commitments
	A-	A3	Strong capacity to meet financial commitments
	BBB+	Baa1	Adequate capacity to meet financial commitments
	BBB	Baa2	Adequate capacity to meet financial commitments
	BBB-	Baa3	Adequate capacity to meet financial commitments
Non-Investment Grade	BB+	Ba1	Speculative characteristics; less vulnerable to near term events than B, CCC, or D
	BB	Ba2	Speculative characteristics; less vulnerable to near term events than B, CCC, or D
	BB-	Ba3	Speculative characteristics; less vulnerable to near term events than B, CCC, or D
	B+	B1	Speculative characteristics; more vulnerable to near term events than BB
	B	B2	Speculative characteristics; more vulnerable to near term events than BB
	B-	B3	Speculative characteristics; more vulnerable to near term events than BB
	CCC+	-	Speculative characteristics; currently vulnerable to near term events
	CCC	-	Speculative characteristics; currently vulnerable to near term events
	CCC-	-	Speculative characteristics; currently vulnerable to near term events
	CC+	-	Speculative characteristics; currently highly vulnerable to near term events
	CC	-	Speculative characteristics; currently highly vulnerable to near term events
	CC-	-	Speculative characteristics; currently highly vulnerable to near term events
	D	-	Default has occurred

Denotes corporate credit rating for Arizona Public Service Co. (ratings of "BBB/A3")

*** Also note that Pinnacle West Capital Corp. maintains senior unsecured ratings of "BBB-/Baa2".

referred to as Moody's.

S & P takes what is called a consolidated approach to the ratings. In doing so, they first rate the basic creditworthiness of the "enterprise" as a whole. Simplistically, this means S & P takes all the cash flow from all the companies in the family and adds it together. Then they take all the obligations from all the companies in the family and add them together. They then compare the cash flow of the "enterprise" to its obligations and arrive at a corporate credit rating based on that relationship. This forms the basis for S & P's ratings. Each family member is then assigned a rating that is close to the "enterprise" rating.

S & P rarely rates family members more than one rating notch away from each other. For example, if the corporate creditworthiness of the "enterprise" is rated a "BBB-", they may assign a "BBB" to the regulated entity to reflect its better business risk, and a "BBB-" to the holding company to reflect the holding company's restricted (by corporate structure, regulatory requirements and accounting rules) access to cash flows within the "enterprise."

S & P has another layer of ratings when a debt obligation is secured by assets. Those ratings will often be many rating notches above the corporate credit ratings to reflect the superior position of the debt holder of a secured debt. The senior secured rating applied to APS is "A-", and remains "A-" despite a lowering of the corporate credit rating from "BBB+" to "BBB" on November 4, 2002 owing to insufficient regulatory insulation between APS and the rest of the PWCC family. S & P's philosophy has been that each company will have a distinct effect on all its affiliates and therefore the corporate credit rating cannot be separated from those of affiliates by many rating notches.

Q. What is Moody's approach and how does it differ from S & P's?

A. Moody's approach to this issue is nearly opposite that of S & P. In 2000, Moody's published a Rating Methodology entitled "Electric Utility Holding Companies" in which they describe their approach. Moody's uses a "building block" approach in which each entity within a corporate family is analyzed on a stand-alone basis. Those ratings will take into effect whether an affiliate's situation has a direct impact on the rated company because of issues like intertwined lines of business where business risks are shared, or a holding company exists that controls the flow of funds within the family.

Assume an electric utility is rated "A2" and a gas company "Baa2" on a stand-alone basis. They happen to be affiliated and a common holding company allocates capital to each affiliate according to its needs. The power company pays a dividend of $100 per year to the holding company. The gas company is an exploration and development company, requiring all of its internally generated cash plus some contribution from the parent to continue increasing its reserves. The parent company is likely to continue to require dividends from the utility at the current, or maybe even a greater rate in order to fund the drilling activity. Therefore, the utility could find its financial cushion for unexpected events depleted. Its rating would reflect that pressure and likely be placed one notch lower than it would otherwise be without that pressure. In addition, the gas company might benefit by one rating notch from the "support" derived from the stronger electric utility. Therefore, the gas company would be rated "Baa1", and the electric utility "A3".

Once all the subsidiaries in the family are rated on this basis, the ratings are "rolled up" in a weighted average to produce a preliminary holding company rating, which in this case might be "Baa1" reflecting a 45% weighting of the "A3" utility, and a 55% weighting of the "Baa1" gas company. The holding company rating is further refined downward if there is a lot of debt at the holding company level.

In our example, let's say there is a lot of holding company debt that was incurred to finance drilling rigs. Moody's would notch the holding company down from the "Baa1" weighted average rating to "Baa3" to reflect (i) required cash to pay the holding company obligations comes from subsidiaries who have first call on that cash, and (ii) the holding company has a lot of debt to be supported. In the summary to the published utility rating methodology, Moody's states that "holding company ratings in the electric sector are widening as largely debt-financed investment is directed to non-regulated activities", and that "the credit risk faced by fixed-income investors are strongly influenced by where they extend credit within the organization".

Q. How do these two differing approaches affect the rating outcomes at PWCC and Arizona Public Service?

A. Please refer to Table 2 below for a comparison of the (i) "benchmark" or corporate credit, (ii) senior unsecured, and (iii) senior secured ratings of the holding company (PWCC) and the regulated utility (APS).

Table 2: Comparison of Holding Company (PWCC) vs. Regulated Utility (APS) Credit Ratings

Col #	1	2	3	4	5	6	7	8	9	10	11	12
	"Benchmark" or Corporate Credit Rating				Senior Unsecured Rating				Senior Secured Rating			
	PWCC		APS		PWCC		APS		PWCC		APS	
	S&P	Moody's	S&P	Moody's	S&P	Moody's	S&P	Moody's	S&P	Moody's	S&P	Moody's
Investment Grade	AAA	Aaa	AAA	Aaa	AAA	Aaa	AAA	Aaa	AAA	Aaa	AAA	Aaa
	AAA-	Aaa	AAA-	Aaa	AAA-	Aaa	AAA-	Aaa	AAA-	Aaa	AAA-	Aaa
	AA+	Aa1	AA+	Aa1	AA+	Aa1	AA+	Aa1	AA+	Aa1	AA+	Aa1
	AA	Aa2	AA	Aa2	AA	Aa2	AA	Aa2	AA	Aa2	AA	Aa2
	AA-	Aa3	AA-	Aa3	AA-	Aa3	AA-	Aa3	AA-	Aa3	AA-	Aa3
	A+	A1	A+	A1	A+	A1	A+	A1	A+	A1	A+	A1
	A	A2	A	A2	A	A2	A	A2	A	A2	A	A2
	A-	A3	A-	$\boxed{A3}$	A-	A3	A-	A3	A-	A3	$\boxed{A-}$	$\boxed{A3}$
	BBB+	Baa1	BBB+	Baa1	BBB+	Baa1	BBB+	$\boxed{Baa1}$	BBB+	Baa1	BBB+	Baa1
	$\boxed{BBB}$	$\boxed{Baa2}$	$\boxed{BBB}$	Baa2	BBB	$\boxed{Baa2}$	$\boxed{BBB}$	Baa2	BBB	Baa2	BBB	Baa2
	BBB-	Baa3	BBB-	Baa3	$\boxed{BBB-}$	Baa3	BBB-	Baa3	BBB-	Baa3	BBB-	Baa3
Non-Investment Grade	BB+	Ba1	BB+	Ba1	BB+	Ba1	BB+	Ba1	BB+	Ba1	BB+	Ba1
	BB	Ba2	BB	Ba2	BB	Ba2	BB	Ba2	BB	Ba2	BB	Ba2
	BB-	Ba3	BB-	Ba3	BB-	Ba3	BB-	Ba3	BB-	Ba3	BB-	Ba3
	B+	B1	B+	B1	B+	B1	B+	B1	B+	B1	B+	B1
	B	B2	B	B2	B	B2	B	B2	B	B2	B	B2
	B-	B3	B-	B3	B-	B3	B-	B3	B-	B3	B-	B3
	CCC+	-	CCC+	-	CCC+	-	CCC+	-	CCC+	-	CCC+	-
	CCC	-	CCC	-	CCC	-	CCC	-	CCC	-	CCC	-
	CCC-	-	CCC-	-	CCC-	-	CCC-	-	CCC-	-	CCC-	-
	CC+	-	CC+	-	CC+	-	CC+	-	CC+	-	CC+	-
	CC	-	CC	-	CC	-	CC	-	CC	-	CC	-
	CC-	-	CC-	-	CC-	-	CC-	-	CC-	-	CC-	-
	D	-	D	-	D	-	D	-	D	-	D	-

$\boxed{}$ Denotes current rating for each entity.

It is important to understand the differences in how S & P and Moody's rate utility companies and their holding company parents. S & P focuses on the corporate credit rating to define the probability that the company will not pay its principal and interest when due, while Moody's uses the senior secured rating to define that probability. Each of these starting points is considered the "benchmark" rating. A careful comparison of the way S & P rates PWCC and APS versus the way Moody's rates

PWCC and APS is also important. The way each rating agency views the relationship between the holding company and the subsidiary has a profound impact on each entity's ratings. The process often causes S & P and Moody's to issue different ratings for the same entity. Currently, S & P has the same "BBB" corporate credit rating for PWCC and APS (columns 1 and 3 above). Moody's, on the other hand, has a "Baa2" rating for PWCC and an "A3" rating for APS (see columns 2 and 4 above).

Moody's, looking at APS as a stand-alone entity, and taking into account its regulated status, its balance sheet, its cash flow, and its affiliation with an unregulated power company concludes that taking its financial condition is commensurate with an "A3". S & P is saying that despite APS' financial performance being better than what S & P considers adequate for a "BBB" (see Exhibit A), there is inadequate regulatory insulation between APS and PWCC and therefore the corporate credit ratings are equal.

III. IMPACT OF TRANSACTION ON FINANCIAL MARKETS

Q. How will the financial markets view refinancing $500 million of debt at APS?

A. Interestingly, two of the rating agencies have already reacted, and one is awaiting the outcome of these proceedings before making any decisions. S & P has already made clear its concern about the lack of separation between PWCC and APS by lowering APS's corporate credit rating to the same level as PWCC on December 4, 2002. In addition, Fitch has expressed its concern about the additional financial leverage and the concurrent diminution of credit quality the proposed refinancing will cause by placing APS on Ratings Watch Negative. How lenders and bondholders react depends on whether the financial markets concur with Moody's or with S & P's approach to rating regulated utilities within a holding company structure. The approaches result in different rating levels.

Q. If PWCC refinances $500 million of debt at the APS level, what do you believe S & P would do?

A. S & P has indicated with the November 4, 2002 downgrade of APS' corporate credit rating to "BBB" that there is no distinction remaining between APS and PWCC. This action reinforces the traditional "enterprise" approach S & P takes. Therefore, the "enterprise" approach should dictate that since the same amount of obligation exists within the enterprise, and the same level of cash flow is available to service that debt, that there would be no reason to revise the ratings further. Financial metrics would remain the same, and under S & P's ratings matrix, APS has stronger metrics than necessary on a stand-alone basis for the "BBB" category (see Exhibit A). Obviously, the parent company debt is a drag on APS' rating reflecting S & P's view that APS is likely to be obligated by PWCC debt. S & P's downgrade of APS' corporate credit rating to "BBB" on November 4, 2002 is based at least in part on a lack of regulatory insulation between APS and the unregulated affiliates. The proposed transaction, if anything, further degrades the insulation between the members of the PWCC family. Certainly, the transaction does not strengthen APS' credit standing with S & P despite the better than "BBB" financial metrics. Thus, given S & P's concerns about closer ties between APS and PWCC, the transaction increases the ratings risk to APS.

Q. What do you believe Moody's would do under the same circumstances?

A. It is likely that Moody's would downgrade APS' rating by at least one notch because the important financial metrics by which they derive their ratings will deteriorate. An additional $500 million in debt at APS would give rise to an additional amount of interest that must be paid. The cash flow from APS' tariff rates will not change. Therefore, the relationship between financial obligations and cash flow will deteriorate. A simple analysis of the effect of the additional debt burden on the company shows that financial indicators deteriorate to a level more consistent with a "Baa1" rating (see exhibit B).

Moody's regards four financial indicators as highly important in a financial analysis, including

1. Cash Coverage of Interest Expense. Cash coverage of interest expense is the ratio that shows how much cash a company is receiving from its customers in relation to how much interest it owes its creditors. This indicates how much extra cash a company has in relation to what it owes. If the amount of cash available relative to interest owed is larger, the greater the ability is of a company to withstand unexpected occurrences that may require spending additional cash. It is not unlike the analysis an individual would do to determine what size mortgage he or she could afford. The mortgage payments can not be larger than a certain portion of the pay an individual takes home. Otherwise, there isn't enough money for food, or to repair the roof after

a storm, or to buy new sneakers for the kids before school starts. If APS takes on the additional financial obligation of $500 million, cash coverage of interest expense deteriorates approximately 25% from 3.96x to 2.96x.

2. Funds from Operations as a Percentage of Outstanding Debt. Funds from operations as a percentage of outstanding debt measures how much cash a company is receiving from its customers in relation to the amount of debt it has borrowed. This indicates how long it would take to pay back all of its debt if a company chose to do so. Again, if one wished to pay off ones mortgage early, the amount of cash available to do that is similar to the concept of funds from operations as a percentage of outstanding debt. People do not necessarily want to pay off their mortgages early, and companies do not want to pay off all their debt early. But if either a person or a company wanted to, they would need to understand how many years it would take given the amount of cash annually. It is a way to understand a company's debt burden in relation to its cash flow. Higher percentages indicate that a company will more easily withstand unforeseen negative financial events. For APS, this measure deteriorates from 24% to 18%, which is 25% below current levels.

3. Debt to Total Capitalization. The debt to total capitalization ratio measures how much debt a company has borrowed relative to how much equity it has raised or generated through retained earnings. This metric shows whether a company has depended on (i) borrowed funds or (ii) funds committed by equity investors or generated internally more. Or, relating it again to the individual, it's like asking "How much do you currently owe versus how much have you saved over time?".

This ratio deteriorates after including the $500 million refinancing/guarantee from 47% to 53.2%, which is 13% below current levels.

4. Pre-tax Interest Coverage. Pre-tax interest coverage is an annual calculation of how much income a company is receiving from its customers in relation to interest owed. Importantly, the calculation of pre-tax interest coverage is based on accepted accounting rules rather than cash available. Cash coverage of interest expense, the first metric discussed above, is based on cash flow. The financial community prefers cash coverage of interest expense over pre-tax interest coverage. Cash coverage calculations are more accurate because pre-tax interest coverage is calculated using income statements formulated according to accounting principals that are subject to interpretation. Pre-tax interest coverage is therefore less directly comparable from one company to another. In addition, the income statement contains numerous non-cash items that can result in a different result from interest coverage calculated using cash flow. Pre-tax interest coverage deteriorates from 4.77x to 3.81x.

Each of these metrics are important in a financial analysis because together, they show how much financial flexibility a company has. The greater the deterioration in these metrics, the more difficult it is for a company to sustain financial health during difficult times. Since companies have to pay their obligations in cash, I would argue that #1, Cash Coverage of Interest Expense, and #2, Funds from Operation as a Percentage of Outstanding Debt are the more important of the four metrics.

Q. Why are those two statistics the more important out of the four?

A. Ratings essentially reflect the ability of a borrower to pay its obligations. It is not unlike the financial situation of any individual. If he or she has enough money in a checking account to pay the bills, they are in good shape. If he or she has extra, they have a nice cushion for unexpected circumstances. If they don't have enough cash to pay the bills, they are in trouble. Therefore, any metric that delineates the cash available to cover the "bills" is going to be scrutinized by the agencies more than other less direct indicators. Debt to total capitalization, for instance, does not address the ability of the organization to pay its debts. It merely defines how much debt exists relative to equity but not the ability to service it. For instance, if a utility had to write off a significant amount of equity for some reason, but regulators allowed it to maintain the previous level of rates (i.e. not reducing rates to reflect returns on a reduced amount of equity) cash flow would remain the same, but the metric "debt to total capitalization" would deteriorate. Nevertheless, the level of debt would remain the same, and the level of cash flow to service that debt would remain the same, making the debt to capitalization metric less meaningful.

Q. What is the effect of a lower rating?

A. Primarily, a lower rating will result in increased costs of borrowing money. Thus, its impact will not be fully felt until time passes. Low ratings also makes it more difficult for a company to do business with its counterparties who require more stringent terms of trade for lesser rated (and therefore riskier) entities. For instance, if an individual had missed payments on a car in the past, it would be more difficult to get a new personal loan. However, if that individual were to put up his or her house to secure the loan, he or she might be awarded a personal loan.

Likewise, companies whose creditworthiness deteriorates find that other companies with whom they do business want some kind of assurance that they will get paid for the goods and services provided. This may entail a security of some kind, or an up-front payment. The lower the credit rating, the greater the security required.

In APS' case, a downgrading from "A3" to "Baa1" could result in an additional 63-129 basis points cost, (or, since a "basis point" equals one tenth of one percent, an extra 0.63% to 1.29% based on the high and low spread over 7 year treasuries in the past 12 months) or $3,150,000 to $6,450,000 on the additional $500 million alone. If all APS debt were to be refinanced the additional cost would be $13,923,000 to $28,969,362. Any additional interest costs would eventually have to be paid for by ratepayers as (i) APS' debt matures and has to be refinanced at rates commensurate with its new, lower credit rating, or (ii) as APS accesses the short term market for funds to support working capital needs for standard maintenance requirements.

Q. How will the financial markets view a refinancing at the APS level given the two different approaches at the major rating agencies?

A. Again, it depends on whether the markets view Moody's approach or S & P's approach to be more appropriate. If the market favors Moody's approach APS could pay up to 63 to 129 basis points more for money with a "Baa1" rating than an "A3" rating, according to Moody's utility yields chart of November 25, 2002.

The $500 million would be deemed by Moody's to be "new" debt obligations of APS. The new debt causes an additional expense of $3 million to $6.5 million in annual additional debt service on the $500 million borrowed depending on interest rates at the time, and the important financial metrics upon which Moody's relies fall out of the zone of comfort they currently enjoy.

It is difficult to account for exactly what determines bond prices since prices reflect many factors including credit quality, maturity, and general conditions in the bond market (how much money is available for investment, etc.). Bond prices also reflect future events, particularly if an issuer is placed on negative or positive "outlook" or is on a "watchlist" for upgrade or downgrade by the rating agencies As the table below indicates, interest rates for an unsecured APS issue were 175 basis points above Treasury rates during the week of September 2, 2002.

Table 3: Spreads During the Week of September 2 to September 6

Issuer	Rating ** S&P	Rating ** Moody's	Ratings Comparison	Basis Point Spread Over Treasuries
Dominion Resources	BBB+	Baa1	Consensus	158
Carolina Power & Light	BBB+	Baa1	Consensus	165
Oncor Delivery	BBB	Baa1	Split: Moody's higher	172
APS	BBB	Baa1	Split: Moody's higher	175
Cinergy Corp.	BBB	Baa2	Consensus	350

** Rating of the issue being traded
Source: Barclay's

A close examination of Table 3 provides some interesting anecdotal evidence about the value the market places on Moody's and S & P's ratings. Oncor Delivery, an operating subsidiary of TXU is, similar to APS, rated the same as its parent by S & P, but two rating notches different by Moody's. Its debt traded that same week at 1.72 percentage points over treasury rates, close to the 1.75% over Treasuries that APS traded. The similarity in interest rates between these two issuers would indicate that bondholders regard the credit quality of Oncor and APS to be similar. Moody's rates Oncor and APS "Baa1". S & P rates them both "BBB", one rating notch lower than Moody's. Nevertheless, they trade in a similar trading range to Dominion Resources (1.65% over Treasuries) and Carolina Power & Light (1.58% over Treasuries) which are rated "BBB+"/"Baa1" (the same rating levels) by S & P and Moody's.

On the other hand, Cinergy Corporation traded at 3.5% over Treasuries. Cinergy is rated "Baa2" by Moody's and "BBB" by S & P. While Cinergy has the same S & P rating as Oncor Delivery and APS, it trades at drastically different spreads in the market. However, Cinergy is the only borrower in the group to be rated lower by Moody's than Oncor, APS, Carolina Power & Light and Dominion. It is also the only one of the group to trade at dramatically different levels than the other. Of these five issuers, investors demand similar additional interest over Treasuries when (i) Moody's and S & P rate issuers the same, and (ii) when Moody's rates the issuer the same but S & P, because of its unique enterprise approach, rates the issuer lower than Moody's.

In these cases, it appears (i) that the market is more comfortable with Moody's ratings when S & P's ratings were derived from their unique "enterprise" approach, and (ii) the market demanded a consistent premium when the two agencies rated a company the same. While this evidence doesn't prove unequivocally that the market prefers Moody's methodology to S & P's, it would seem that in these instances, bond investors require different payment for issuers like Oncor and APS, and Cinergy, which Moody's rates differently, even though S & P rates them all the same. Whether the markets favor Moody's or S & P's approach has never been empirically proven. However, anecdotal evidence would point to Moody's approach being more readily accepted than S & P's.

IV. PROTECTING APS AND ITS RATEPAYERS

Q. APS has identified the financing as a way to protect APS ratepayers from potential APS credit downgrades as a result of PWCC troubles. Do you believe that is the right approach to protecting APS ratepayers from PWCC problems?

A. Not at all. As I identified above, refinancing the debt at APS is likely to result in a credit downgrade from Moody's. S & P has already downgraded APS as a result of its ties to PWCC and Fitch has put APS on credit watch. These factors lead to a conclusion that APS and its ratepayers need more separation from PWCC and its liabilities than an increased connection.

Q. Wouldn't approving APS' request protect APS from harm by preventing default by PWCC?

A. Not necessarily. First, while APS' proposal may protect PWCC in the short-run by providing refinancing of the existing PWEC debt, there is certainly no guarantee that PWEC and/or PWCC will not default on their obligations It is unclear what the default and remedy provisions of the proposed transaction will be. More importantly, while the proposed transaction benefits Pinnacle West, as I said before, it presents serious risk to APS. The proposed refinancing (i) degrades the existing separation between APS and its affiliates, which, as we have seen with S & P recent downgrade, is disfavored by the financial markets, (ii) opens APS to potential liability from corporate commingling and violation of existing affiliate rules, and (iii) exposes APS to potential ratings downgrades and credit degradation. The choice is really quite clear – the Commission can protect APS and its ratepayers, or expose APS and its ratepayers to risks faced by the unregulated affiliate, risks the Commission had no say in PWCC undertaking!

Q. Should Panda Gila River's concern about the assets moving to APS also be an area of concern for APS ratepayers?

A. Yes. As I noted above, once the loan is made by APS, there will likely be increasing pressure on APS to seek rate base treatment of the PWEC assets. Although the Commission's order in Decision No. 65154 was clear that "[t]he results of the proceeding on such application shall not affect the amount, timing, and manner of the competitive procurement process" once the assets transfer, whether that be by request or through operation of contract, the pressure to change that outcome will be greater. In that scenario the ratepayers lose the flexibility to seek the lowest cost energy supply.

Q. To what extent, if any, is your opinion as to the appropriateness of the refinancing at the APS level influenced by the fact that the debt in question was raised by PWCC for the benefit of PWEC which was originally intended to be a competitive merchant generator with a portfolio of assets that could compete with other large generators in the West?

A. From a credit perspective, the partial retreat from deregulation in Arizona is a plus for APS and PWCC. More of the assets will continue to be regulated, and while the potential upside for PWEC/PWCC is gone, the downside, which as we've seen can be quite severe, has also been eliminated. Fixed income holders and rating agencies are much more comfortable with stability and predictability than the potential for a company to "hit a homerun". Contrary to Ms. Gomez' contention in her October 11, 2002 testimony in referencing the agencies' views on the potential for PWEC to capture market rates versus a PPA, she erroneously assumes that "it may have appeared to them [the agencies] more advantageous to PWEC, given then projected market prices, than did their alternative assumption of a short-duration PPA." She is completely off base with this assumption. All rating agencies and fixed income investors prefer the known to the unknown. Therefore, higher prices that could be charged in a mostly spot energy market such as the one experienced in California in 2000 are considered far less desirable than stable, predictable revenues derived from a regulated or bilateral environment, simply because open market rates change unexpectedly, and rapidly. Regulated, or any other contractually based, revenues are steady and only change after a formal rate case process or contract termination or modification.

That fact notwithstanding, the debt taken on by PWCC would not have been incurred if PWEC had not been formed. APS does not benefit from the incurrence of that debt. PWEC, however, has 1700 MWs of power that was built using the proceeds of that debt. It therefore is more appropriately carried at the parent level if PWEC can't refinance on its own given current circumstances.

Q. Is there an economic argument for refinancing at the PWCC level?

A. Yes. If the debt were merely refinanced at that level, everything would remain as it is. S & P should continue to apply its "enterprise" approach to the PWCC family although it may revert to a higher rating for APS than PWCC if it viewed the denial as a sign of regulatory insulation of APS, and Moody's would continue to consider APS a reasonably sound A3 vertically integrated regulated utility. In addition, to PWCC's benefit, there will be less unregulated cash flow in the system, providing for more stability and predictability than it would have had PWEC taken all of the generating assets into an unregulated, unpredictable and highly volatile merchant market. APS will be able to continue to provide cash flow to PWCC in the form of $170 million in dividends, as it has been, and allow PWCC to service the debt. In addition, those dividends will not have to support a growth strategy at PWEC, and the risk associated with its merchant generation is greatly reduced, strengthening the business position of the entire family.

Q. What do you recommend?

A. Based on my testimony above, I recommend that the Commission reject the application to finance merchant debt, whether that be via a loan or guarantee, at the regulated utility level. The proposed financing not only has no benefit for APS ratepayers, it creates a number of risks that are unnecessary and inappropriate.

Q. Does this complete your testimony?

A. Yes it does.