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December 30, 2002

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

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

Dear Sir or Madam:

Pursuant to the Procedural Order dated October 9, 2002, Docket No. E-01345A-02-0707, Arizona Public Service Company is hereby filing a correction in the rebuttal testimony of Barbara M. Gomez. Exhibits BMG-1R through BMG-3R should be been referred to as Schedules BMG-1R through BMG-3R. No other changes to either the attachments or the text of her rebuttal testimony were made.

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

Sincerely,

Jana Van Ness/vld

Jana Van Ness
Manager
Regulatory Compliance

Attachment

JVN/vld

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Service List

Arizona Corporation Commission
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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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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 <u>entirely</u> "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 <u>its</u> 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 <u>will</u> 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 <u>not</u> 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.

SCHEDULE

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.

SCHEDULE

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.

SCHEDULE

BMG-3R

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'.

FitchRatings

Corporate Finance

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 philip.smyth@fitchratings.com	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.