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AZ CORP COMMISSION
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January 3, 2003

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

RE: ARIZONA PUBLIC SERVICE COMPANY'S SUMMARIES OF TESTIMONY IN THE MATTER OF THE THE FINANCE APPLICATION
DOCKET NO. 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 the written summaries of previously filed testimony for Mr. Jack E. Davis, Ms. Barbara M. Gomez and Mr. Arthur H. Tildesley.

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

Sincerely,

Jana Van Ness

Jana Van Ness
Manager
Regulatory Compliance

Arizona Corporation Commission
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Summary of Jack E. Davis Rebuttal Testimony

I very much agree with Utilities Division Staff ("Staff") witness John S. Thornton, Jr., and Residential Utility Consumer Office ("RUCO") witness Mary Lee Diaz-Cortez that granting the Application is in the public interest. I will support that conclusion by reminding the Arizona Corporation Commission ("Commission") of the origins of Pinnacle West Energy Corporation ("PWEC") and its intended relationship with Arizona Public Service Company ("APS" or "Company"). I also will defend the financing plan used to pay for PWEC's construction program from the unsupported claims of Panda Gila River, L.P. ("Panda/TECO") witness Susan Abbott. Finally, I wish to discuss the existing regulatory insulation of APS from potential affiliate abuse and explain the APS position with regard to the Staff's proposed dividend limitation. Such a limitation is one of the conditions Staff has requested that the Commission adopt in its approval of the Company's Application.

In evaluating the public interest criteria discussed by both Mr. Thornton and APS witness Barbara M. Gomez, as well as other witnesses, the Commission must consider all of the benefits realized as a result of granting the Application rather than getting hung up on parsing the various specific terms used in Title 40, Arizona Revised Statutes. And it cannot be forgotten that PWEC was created as a direct result of, and would never have existed absent, the 1999 APS Settlement and the Commission's Electric Competition Rules. Its two primary purposes were to receive the APS generation units divested pursuant to that Settlement and to construct new generation for APS customers so that these customers would not be wholly dependent on the vagaries of the wholesale electric market for reliable and reasonably-priced generation. In this role, PWEC could also serve as a competitive check on that wholesale market to the long-term benefit of APS and its customers.

The financing plan that PWCC put together was intended to produce the lowest cost of constructing that generation consistent with the mandated divestiture date of December 31, 2002. That plan was reviewed and validated by independent rating agencies. It was working, and it would have continued to work had APS been allowed to divest its generation to PWEC as was originally agreed to by the Company and the Commission.

APS is subject to intense and overlapping affiliate regulation at both the state and federal level. That regulation provides significant and explicit "regulatory insulation" to APS. Indeed, the very existence of this proceeding is a prime example of that insulation—a fact that some of the witnesses and, unfortunately, some debt rating agency analysts, choose to ignore.

The APS Board of Directors is charged with setting the dividend policies of the Company. As one of those Directors, I can tell you that we take that responsibility seriously and would not agree to Staff's proposed dividend limitation unless we believed it in the interests of both APS and PWCC under the special and unique circumstances of this case. As proposed by Staff, and with the clarification suggested by Ms. Barbara Gomez in her Rebuttal Testimony, it is a condition to the approval of our Application that is acceptable.

Summary of Barbara M. Gomez Direct Testimony

First, I will explain to the Commission the plan for permanent financing of the new generation constructed or being constructed by PWEC that was in effect prior to the entry of Decision No. 65154 (September 10, 2002). Second, I discuss the significantly negative impact of Decision No. 65154 on that permanent financing plan. Third, I will describe the Company's proposal to partially recover from this particular aspect of Decision No. 65154 through an inter-company loan, a corporate guarantee, or a combination of both. Finally, I analyze the impact of the Company's financing proposals on APS. When taken together, my testimony will establish that the APS proposals are, in the words of A.R.S. § 40-301 (C): "for lawful purposes which are within the corporate powers of the applicant [APS], are compatible with the public interest, with sound financial practices, and with the proper performance by the applicant [APS] of service as a public service corporation and will not impair its ability to perform that service."

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

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

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

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

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

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

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

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

Summary of Barbara M. Gomez Rebuttal Testimony

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.

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.

Summary of Arthur H. Tildesley Direct Testimony

In light of the Arizona Corporation Commission's ("ACC") decision on August 27, 2002 reversing both its requirement that Arizona utilities divest their generation assets and its previously unqualified approval for the transfer of APS generation to PWEC, Salomon Smith Barney, Inc. ("SSB") was asked by APS to address the following questions:

1. Does Pinnacle West Energy Corporation ("PWEC") presently have access to the capital markets on a standalone or non-recourse basis?

2. Do we believe that PWCC is likely to experience a credit rating downgrade if no action is taken to refinance the debt incurred at PWCC to temporarily finance the construction of PWEC generation assets ("the Bridge Debt") at an operating company level, either APS or PWEC?

3. Is a financing plan involving an intercompany loan or guarantee provided by APS to PWEC feasible in the current capital markets environment?

4. What is the impact on the credit quality of APS of the proposed intercompany loan or guarantee by APS to PWEC?

Based on our analysis, we have come to three basic conclusions:

1. If PWEC is not able to obtain new debt financing on a standalone or non-recourse basis, and therefore the PWCC Bridge Debt must be refinanced at the parent level as permanent parent debt, it is possible that the credit quality of PWCC will suffer.

2. PWEC does not have access to third-party debt financing on a non-recourse basis in any meaningful amount.

3. The alternative financing plans of either an intercompany loan or a guarantee from APS to PWEC provides a financeable and cost-effective transition plan for continuing the funding of the PWEC generation. Our analysis confirms that APS has excess debt capacity sufficient to allow it to borrow approximately $500 million without significant impact on the current credit quality of APS. We further expect that a supportive action by the ACC would be viewed positively by financial market participants as a constructive regulatory action that would help offset to the uncertainty created by the ACC's reversal of the divestiture plan.

Summary of Arthur H. Tildesley Rebuttal Testimony

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

- his conclusion that the potential weakening in Arizona Public Service Company's (APS) financial ratios resulting from the issuance of an additional $500 million of debt is significant and would negatively impact the Company;

- his statement that my conclusions on the limited ability of Pinnacle West Energy Corporation (PWEC) to access financing are "speculative and unsupported by documentation;" and

- his assertion that my conclusions regarding the impact of PWEC market access on Pinnacle West Capital Corporation (PWCC) credit quality are "speculative and unsupported by documentation."

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