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AZ CORP COMMISSION
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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; TO LEND
MONEY TO AN AFFILIATE OR AFFILIATES;
AND TO GUARANTEE THE OBLIGATIONS OF
AN AFFILIATE OR AFFILIATES

DOCKET NO. E-01345A-02-0707

Arizona Corporation Commission
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ARIZONA PUBLIC SERVICE COMPANY'S
INITIAL POST-HEARING BRIEF

Arizona Public Service Company ("APS" or "Company") hereby submits its Initial Post-Hearing Brief in support of the Company's Application for Financing Authority ("Application").¹

I. SUMMARY OF APS POSITION

APS' parent, Pinnacle West Capital Corporation ("PWCC"), is facing a liquidity crisis that threatens its continued financial integrity. Over three-quarters of a billion dollars of PWCC debt becomes due beginning in July of 2003. The debt was incurred to finance new electric generation built by an APS affiliate, Pinnacle West Energy

¹ Although the presiding Chief Administrative Law Judge indicated that issues not briefed would be deemed abandoned by the parties, APS will not brief every request made by the Application when such request has not to date been put at issue by Staff or intervenor testimony. Should such unbriefed request(s) be now placed at issue by the opening briefs of Staff or intervenors, APS will address them in its Closing Brief.

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1 Corporation (“PWEC”), to serve APS customers. Given the state of the present financial
2 markets, and without the planned divestiture of APS generation to PWEC authorized
3 under terms of the 1999 Settlement Agreement, this PWCC debt cannot be repaid or
4 refinanced on reasonable terms at maturity without credit support from APS as proposed
5 in the Company’s Application.

6 The continued financial deterioration of PWCC inevitably and adversely affects
7 APS credit quality, leading to the potential of at least a one step drop in the Company’s
8 present debt ratings and higher overall capital costs. This would happen either because
9 some debt rating agencies do not distinguish between the two entities in establishing
10 overall enterprise credit quality, or continuing (indeed, exacerbated) regulatory
11 uncertainty arising from the Commission’s Track A decision, or as in this case, the
12 combination of both these factors. There is also the real potential that the generation assets
13 financed by the PWCC debt will have to be sold to outside entities at “fire sale” prices
14 unless the relief requested, and recommended by the Commission’s own Staff, is granted.
15 Such generation assets were constructed for APS’ benefit, and two of the plants were
16 specifically sited in the metropolitan Phoenix area and are vital to continued reliable
17 service to that area. This potential secondary effect of PWCC’s loss of creditworthiness
18 would forever remove both the possibility of that generation’s being subjected to this
19 Commission’s regulatory jurisdiction on the one hand, and the continued viability of the
20 Company’s unregulated generating affiliate as an aggressive competitor for APS load on
21 the other.

22 In contrast, granting the Application risks nothing so far as APS customers are
23 concerned. The Staff’s proposed conditions provide total insulation and regulatory
24 protection against even the most unlikely of circumstances. And although the separate
25 financial analyses of APS credit metrics by both APS and its financial advisor, Salomon
26 Smith Barney, demonstrate the continued financial strength of APS if the Application is

1 granted, and despite the fact that both Standard and Poor's ("S&P") and Moody's have
2 given similar indications, the Company has agreed to these conditions with only minor
3 modification.

4 Granting the Application, subject to the Staff conditions as discussed later in the
5 Company's Initial Brief, provides positive benefits to APS customers as well avoiding the
6 very significant potential harms discussed above. These benefits range from the intangible
7 but very real perceptions by the financial community of continued responsive and fair
8 regulation in Arizona, to the quite tangible prospect of between \$7.5 million and \$13.2
9 million per year of net interest income (plus return) during the term of the loan to PWEC.
10 This income would be deferred by the Company to offset revenue requirements in the
11 upcoming APS general rate proceeding. Staff's Condition No. 7 (restricting APS
12 dividends) provided Staff comfort of further insulation of APS from future harm. And
13 under the Principles for Resolution of Track A Issues signed by both APS and Staff,
14 successful resolution of the Application will moot or otherwise result in the elimination of
15 most of the Track A issues presently subject to litigation.

16 Several of the above benefits are directly related to the ability of the Commission
17 to address, in a direct and meaningful way, the loss of PWEC creditworthiness and
18 subsequent liquidity difficulties of PWCC attributable in significant part to the impact of
19 Decision No. 65154 (September 10, 2002). It will be an important step in restoring the
20 Company and its affiliates to a *status quo ante* position. And it will help fulfill the
21 Commission's stated intent in Decision No. 65154 to act fairly in addressing the
22 consequences of what it believed was a necessary change in direction regarding the issues
23 of divestiture and restructuring.

24 Staff and the Residential Utility Consumer Office ("RUCO"), as well as the
25 Arizona Utility Investors Association ("AUIA") support the Company's Application.
26 Such broad-based agreement by these three entities on any matter before this Commission

1 is rare to say the least. Only Panda/TECO, and perhaps certain other of the merchant plant
2 intervenors, oppose the Application. In contrast to the six witnesses testifying in support
3 of the Application, Panda/TECO presented one having a contrary opinion. The other
4 merchant plant intervenors had not a single witness. Therefore the Commissions must ask
5 itself two simple questions. Who has presented the greater, more substantial and more
6 compelling fact and opinion evidence to support their position? And what are the
7 consequences of their being wrong?

8 If APS, Staff, RUCO and AUIA are right, and the Application is necessary to
9 preserve APS' credit, then denying the Application would be clearly harmful to APS
10 customers. Panda/TECO has promised no indemnification to customers or the public
11 under such circumstances. If APS, Staff, RUCO and the AUIA are wrong, APS ratepayers
12 and the public are still fully protected from any adverse consequences, and they would
13 still receive the other financial and regulatory benefits stemming from the Application's
14 approval.

15 In sum, the Commission is at a regulatory "fork in the road." One path protects
16 customers, provides substantial positive benefits, and is responsive to the unique
17 circumstances arising from Decision No. 65154. The other needlessly risks great harm to
18 the Company and its affiliates, produces no new benefits, and would clearly be viewed as
19 punitive and unresponsive by the financial community. APS does not believe the
20 Commission's choice of direction a difficult decision.

21
22 **II. INTRODUCTION AND BACKGROUND**

23 APS filed the instant Application to address the serious liquidity problems
24 affecting its affiliates PWCC and PWEC—problems which in turn impact APS both in
25 terms of credit quality and the ability to secure permanent financing for some 1750 MW
26 of generation planned and constructed to serve APS customers. Although APS readily

1 acknowledges that the wholesale electric market in the West and the national financial
2 market for electric generation have changed dramatically over the past year or so, it is
3 equally true that a significant element contributing directly to the current crisis involving
4 PWCC and PWEC is the Commission's decision to block divestiture of APS generation to
5 PWEC without at the same time addressing the impact of that decision on the financial
6 structure put in place by PWCC in reliance on such divestiture. (*See* Decision No. 65154;
7 *see also* B. Gomez Direct Test. at 2-3, 9 and J. Davis Rebuttal Test. at 7.)

8 In recognition that the present circumstances arise from convergence of power
9 market, financial and regulatory events—a “perfect storm” if you will—PWCC has taken
10 several important steps on its own to address the resulting liquidity concerns. Specifically,
11 PWCC has reduced capital expenditures by canceling Redhawk Units 3 and 4. It recently
12 issued \$200 million in common equity, and it is accelerating the sale of SunCor's real
13 estate assets to generate cash flow. These are significant steps that limit PWCC's and
14 PWEC's future business prospects and underscore the severity of the situation. The
15 authorizations requested in the Application are necessary to complete PWCC's “Recovery
16 Plan.” (B. Gomez Direct Test. at 12-13; Tr. vol. I at 90-93, 113, 217-218 [B. Gomez].)

17 18 **III. DESCRIPTION AND ORIGINS OF THE PRESENT LIQUIDITY CRISIS**

19 PWEC was to receive all of APS' generation no later than year-end 2002 under the
20 1999 APS Settlement and the Electric Competition Rules. Contingent upon such receipt,
21 PWEC obtained investment-grade credit ratings from all the major credit agencies. (B.
22 Gomez Direct Test. at 6 & Sch. BMG-1.) However, prior to such divestiture, it became
23 necessary for PWEC to initiate a billion-dollar generation construction program to assure
24 continued reliable service to APS customers. (B. Gomez Direct Test. at 7-8; J. Davis
25 Rebuttal Test. at 4-5; Tr. vol. II at 397 [J. Davis]; *see also* APS Exh. 11 through APS Exh.
26 18.)

1 The most cost-effective way of providing interim or bridge financing for this
2 program was to incur short-dated debt at PWCC and then replace that debt with
3 permanent financing at PWEC using the latter's corporate credit post-divestiture. (B.
4 Gomez Direct Test. at 8; Tr. vol. I at 173-174 [B. Gomez].) Because PWCC had the
5 capacity to provide bridge financing until 2003, and PWEC had the ability to secure long-
6 term financing post-2002 (that is, post-divestiture) there was no need to utilize more
7 expensive and restrictive project financing. (B. Gomez Direct Test. at 8-9.) Neither was it
8 appropriate to involve APS in either the financing or construction of new generation—
9 generation that, under the regulatory plan then required by the Commission, would shortly
10 have to be divested to PWEC in any event.² Consequently, PWCC will have borrowed
11 some \$1.1 billion by March of 2003, with the first \$475 million of that maturing at the end
12 of July 2003.³

13 Under present market conditions, PWEC has no ability to refinance the PWCC
14 debt without the APS generation. (*See, e.g.*, A. Tildesley Direct Test. at 5; Tr. vol. III at
15 767 [S. Abbott].) Those same market conditions also prevent PWCC from refinancing that
16 debt without doing significant and perhaps fatal damage to its own continued
17 creditworthiness. (*See* Section IV.A, *infra*; *see also* B. Gomez Direct Test. at 9-11; A.
18 Tildesley Direct Test. at 10; and A. Tildesley Rebuttal Test. at 6-7.) Although, as
19 discussed above, PWCC is taking all prudent steps to tap other sources of cash to address
20 this liquidity problem, it was determined that it was both safe (to APS) and prudent (from
21 the point of view of APS) to submit the Application under consideration in this
22 proceeding.

23 ² Under such circumstances, APS saw no need, and indeed no justification, for seeking a waiver of
24 the Code of Conduct provisions that prevented new generation construction and financing at the APS
level.

25 ³ Both of these amounts are lower than set forth in the Application because PWCC's December
26 2002 common equity issuance was used to reduce both Bridge Debt and outstanding commercial paper
obligations of PWCC.

1 In citing Decision No. 65154 as a significant contributing factor to the
2 circumstances leading to the Company's Application, one need not draw any negative
3 conclusions concerning the wisdom or necessity of such Decision. Even the most
4 seemingly necessary actions can have unintended and adverse consequences to innocent
5 parties. Thus, the postulations by several of the witnesses, including Mr. Davis, that
6 Decision No. 65154 might itself have been an appropriate (if incomplete) Commission
7 response to the then existing state of the wholesale electricity market, cannot alter the
8 simple fact that the Commission's action, combined with other regulatory actions over a
9 period of years, have directly contributed to the unique situation and current liquidity
10 concerns faced by APS and its affiliates—concerns that now represent unfinished work as
11 regards Decision No. 65154. Nor does the equally obvious fact that deteriorating financial
12 markets exacerbated those same concerns alter this Commission's need to address them in
13 a fair and timely manner. And, just as Decision No. 65154 cannot be viewed in isolation
14 from the surrounding chaos of the energy and financial markets, neither can it be
15 understood without historical context.

16 Since 1998, APS had continuously planned to divest all of its generation. This
17 restructuring of the way APS had conducted its business for nearly a century was clearly
18 required by the Commission's Electric Competition Rules and had been specifically
19 authorized by the Commission in the 1999 Settlement Agreement as being in the public
20 interest. PWCC's financing plans for the next generation of plants needed to serve a fast-
21 growing service area were based on, and entirely consistent with, this long-standing and
22 clear Commission direction toward a separate and competitive generation structure, with
23 all such generation falling under a unitary financing (and regulatory) regime.⁴

24 _____
25 ⁴ A short history of this state's evolving electric restructuring program is perhaps instructive at this
26 point. It is also illustrative of the current situation in certain respects. Specifically, in December of 1996, Arizona completed a two-year investigation into electric competition and electric industry restructuring by promulgating the original set of "permanent" Electric Competition Rules. See Decision No. 59943

1 As can be seen from the above discussion, APS and its affiliates have acted
2 consistent with Commission guidance and directives in incurring the bridge financing.
3 The Application now seeks to address those changes in the direction of industry
4 restructuring required by the Commission in a manner that is compatible with the existing
5 financial market, protects APS customers, and provides positive benefits to such
6 customers. And, significantly, all of the entities (Staff, RUCO, AUIA, and APS) charged
7 with representing the public interest, the interests of APS customers, and the interests of
8 APS investors—the three constituency groups to be served by the Commission—agree.

9
10
11 (December 26, 1996). These original regulations did not require divestiture, which the Commission
specifically rejected.

12
13 In the Spring of 1998, the Commission circulated for comment a revised set of “permanent”
14 Electric Competition Rules that now required divestiture to a non-affiliated party. APS—and Tucson
15 Electric Power Company (“TEP”), for that matter—strenuously opposed that provision of the proposed
16 rules. This provision was subsequently modified to add an option allowing divestiture to an affiliate, which
17 modification was adopted on an emergency basis in Decision No. 61071 (August 7, 1998) and confirmed
18 in the 1998 version of the Commission’s “permanent” Electric Competition Rules. *See* Decision No.
19 61272 (December 11, 1998). This new path for mandatory electric industry restructuring resulted in a
three-way settlement agreement between Staff, APS and TEP. Under this agreement, APS would acquire
most, but not all, of TEP’s generation in exchange for most, but not all, of APS’ transmission. The
combined APS/TEP generation would then be spun off into an APS subsidiary. That settlement was filed
with the Commission on November 4, 1998, and a hearing scheduled for December 3, 1998. Justice Jones
of the Arizona Supreme Court granted an injunction against such hearing, and the three-party settlement
itself was withdrawn by year’s end.

20 The 1998 set of “permanent” Electric Competitions Rules did not long survive the ill-fated 1998
21 APS/Staff/TEP settlement, lasting all of 10 days before being suspended by Decision No. 61311 (January
22 11, 1999). Four months later, the 1999 edition of the “permanent” Electric Competition Rules was issued
23 retaining the same divestiture provision as their 1998 counterpart. *See* Decision No. 61634 (April 23,
24 1999). It was to this version of the Electric Competition Rules, which were adopted a few days prior to
25 approval of the 1999 APS Settlement that the 1999 APS Settlement referred. *See* Decision No. 61969
(September 23, 1999) The 1999 APS Settlement specifically made the Commission a party to its terms,
including those authorizing divestiture of all APS generation to PWEC. The 1999 APS Settlement was
later upheld as a binding contract between the Commission and APS by the Arizona Court of Appeals in
the Spring of 2001, having withstood legal challenges from both Enron and the Arizona Consumers
Council. *Arizona Cons. Council v. Arizona Corp. Comm’n*, CC99-0006 (Ariz. Ct. App., April 5, 2001).

1 **IV. IMPACT ON APS**

2 **A. PWCC Will Be Downgraded if the Application is Denied**

3 There was no credible evidence contradicting the inescapable conclusion that
4 PWCC would be downgraded if the Commission were to deny the Application, forcing
5 PWCC to either repay or refinance all of the bridge debt.⁵ Ms. Gomez discussed in her
6 testimony that PWCC could not continue to carry the amount of bridge debt, because the
7 bridge debt is already above amounts that would support PWCC's current credit rating.
8 (B. Gomez Direct Test. at 10.) Additionally, the debt rating agencies are increasingly
9 concerned with debt held at the holding company level, and PWCC cannot itself
10 collateralize the loans on its own. (*Id.*) If a credit downgrade were to result from any
11 PWCC attempt to refinance the bridge debt—a downgrade to below investment grade
12 status—PWCC would not only face higher borrowing costs, but, more importantly from a
13 liquidity standpoint, would lose access to the commercial paper market and would face
14 very limited access to public credit markets on any terms. (*Id.* at 11.) Two of the three
15 primary debt ratings agencies—and indeed, the two most widely relied upon of such
16 agencies—have signaled publicly that they would downgrade PWCC if the Application is
17 denied. (*See* B. Gomez Rebuttal Test. at 18.)

18 S&P in its November 4, 2002 release stated:

19 . . . the stable outlook [for PWCC] reflects the assumption that the ACC
20 will approve the application to issue up to \$500 million at APS to repay a
21 portion of the \$750 million bridge financing at PWCC that was done to
22 build assets at PWEC, as required by the 1999 settlement agreement with
the ACC.

23 (Staff Exh. 4.)

24 ⁵ Panda witness Abbott claimed to have done an analysis of PWCC's ability to refinance the debt,
25 but did not present for the Commission's consideration or even discuss that analysis in her testimony.
When asked on cross-examination why she had not discussed this analysis of PWCC, she stated that she
26 had not been asked to evaluate PWCC. (Tr. vol. IV at 762 [S. Abbott].) Ms. Abbott did not refute any of
the reports supporting Ms. Gomez and Mr. Tildesley's conclusion that PWCC has no such ability.

1 Moody's had earlier indicated on September 9, 2002 that:

2 the rating outlook [for PWCC] is stable and assumes the Pinnacle West
3 bridge financing is refinanced at an operating subsidiary in the
4 intermediate term. Failure to do so could have negative ratings
implications.

5 (APS Exh. 6; *see also* Tr. vol. IV at 994 [J. Thornton].)

6 Finally Fitch stated on December 17, 2002:

7 Fitch recently placed the BBB senior unsecured debt ratings of PNW on
8 rating watch negative citing concern over the company's ability to
9 refinance \$790 million of maturing [debt] over the next 14 months,
10 increasing exposure to merchant energy markets, and the uncertain
11 regulatory treatment of 1800 mw of new generation. The rating watch
12 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.

13 (B. Gomez Rebuttal Test. at Sch. BMG-3R.)

14 Additionally, Mr. Tildesley agreed that, from an arranger-underwriter's
15 perspective, PWEC could not itself refinance the bridge debt, which would in turn
16 negatively impact PWCC's credit quality. (A. Tildesley Rebuttal Test. at 6-7; Tr. vol. II at
17 362 [A. Tildesley].) This is especially significant because Salomon Smith Barney, and Mr.
18 Tildesley in particular, have hands-on experience raising countless billions of dollars for
19 the energy industry. (A. Tildesley Direct Test. at 2-3; A. Tildesley Rebuttal Test. at 2.)

20 **B. The Failure to Approve the Application Will Adversely Affect APS and
its Customers**

21 The evidence shows that the risk of denying the Application is both real and
22 unacceptable. Staff and RUCO both agree that the potential impacts to APS if PWCC is
23 downgraded warranted approval of the Application. (J. Thornton Direct Test. at 4, 5, 15;
24 M. Diaz-Cortez Direct Test. at 7-8, 11.)

25 Ms. Gomez explained in her Direct Testimony that a downgrade of PWCC would,
26 in her opinion, result in negative impacts to APS and its financial integrity. (B. Gomez

1 Direct Test. at 12.) These include the potential for downgrades of APS debt, increased
2 regulatory risk, lack of financial support for generation assets used to serve APS, and
3 reduced competition over the longer run for APS load requirements. (*Id.* at 11-13, 23.) In
4 supporting her analysis, she explained how rating analysts consider enterprise conditions
5 when establishing debt ratings. (*Id.*) S&P, for example, specifically uses an enterprise
6 approach when establishing the debt ratings of both a parent and its affiliates. (*Id.*) Indeed,
7 S&P expressly used this method in its November 4, 2002 release, which downgraded
8 some ratings of both APS and PWCC. However, S&P also stated that “[b]ased on
9 Standard and Poor’s consolidated ratings methodology, the movement of debt from the
10 parent to the subsidiary does not affect the overall financial health of the entities.” (B.
11 Gomez Rebuttal Test. at Sch. BMG-1R.) Because S&P tracks both the parent and
12 subsidiaries together, Ms. Gomez concluded that “any decline in PWCC’s
13 creditworthiness would be reflected in S&P’s evaluation of APS.” (B. Gomez Direct Test.
14 at 12; *see also* Tr. vol. I at 125-26, 154-55 [B. Gomez].) Ms. Gomez also provided an
15 example from Moody’s, which downgraded Allegheny Energy for exposure to wholesale
16 trading losses, and at the same time downgraded all three of its regulated utility
17 subsidiaries even though they had no connection with such losses. (*Id.*)

18 Although the denial of the Application will itself constrain PWCC’s ability to
19 access the capital markets, (*see* Tr. vol. II at 362 [A. Tildesley],) and, as rating agencies
20 have already signaled, will result in a downgrade of PWCC, (*see* Section IV.A, *supra*), the
21 merchant intervenors ask the Commission to take the unnecessary risk that there will be
22 no resulting impact on APS. Yet, once a downgrade occurs, it will be no simple matter to
23 undo the action and upgrade PWCC to the prior rating. (*See* Tr. vol. III at 774 [S.
24 Abbott].) Further, the merchant intervenors have not guaranteed that APS’ customers will
25 be unharmed if the Commission denied the Application and APS’ cost of capital were to
26 increase. In stark contrast, Staff Condition No. 6 requires PWCC to protect APS

1 customers from future rate impacts in the far less likely event that approval of the
2 Application adversely impacted APS.

3 **C. Approval of the Application Will Not Adversely Affect APS**

4 In contrast to the clear indications that PWCC would be downgraded to junk status
5 (with the attendant risk to APS credit quality) if the Application is not approved, the
6 evidence showed that APS and its customer would not be adversely affected if the
7 Commission approved the Application. Specifically, S&P wrote in a November 4, 2002
8 report that lowered some of the debt ratings of both APS and PWCC:

9 [T]hese rating actions are not the result of the company's proposal to move
10 \$500 million of debt from PWCC to APS. Based on Standard and Poors
11 consolidated rating methodology, the movement of debt from the parent to
12 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 of debt.

13 (B. Gomez Rebuttal Test. at Sch. BMG-1R (emphasis added).) In addition to explaining
14 that the approval of the Application would not cause APS to be downgraded, this report,
15 in explaining S&P's consolidated evaluation parents and affiliates, shows how the
16 downgrade of PWCC would adversely affect APS.

17 Panda witness Susan Abbott stated that she believed "it is likely that Moody's
18 would downgrade APS' rating" if the Application were approved. However, after Ms.
19 Abbott's testimony was filed, Moody's confirmed APS' rating in what amounted to an
20 emphatic rejection of Ms. Abbott's speculation to the contrary:

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

26 (APS Exh. 5 (emphasis added).)

1 Fitch had also taken action against both APS and PWCC in fall 2002, placing them
2 both on “Rating Watch Negative.” The basis for Fitch’s action against APS was threefold,
3 including regulatory uncertainty over the upcoming rate case and Track B, as well as
4 approval of the financing. Although the Fitch reports were not as definitive as the S&P
5 and Moody’s reports as to specific impacts to APS from approval of the Application, Ms.
6 Gomez testified that it was her opinion—based on her experience as the Company’s
7 treasurer—that “Fitch would also leave the ratings as is.” (Tr. vol. I at 93 [B. Gomez].)
8 Moreover, Fitch and Moody’s currently rate APS unsecured debt the same, with both
9 higher than S&P. (B. Gomez Rebuttal Test. at 14.)

10 Additionally, the Company described in detail in its testimony how the approval of
11 the Application would affect the various credit metrics that are used by ratings agencies to
12 evaluate companies. Mr. Tildesley, of Salomon Smith Barney, analyzed the Application
13 and concluded that APS’ “business fundamentals and credit statistics are strong” and that
14 the loan would not impair “fundamental utility credit quality.” (A. Tildesley Direct Test.
15 at 9.) Indeed, Mr. Tildesley’s analysis was conservative, assuming for purposes of
16 analysis that PWEC would not service the loan and that APS would have to absorb fully
17 the costs of the loan on its books. (Tr. vol. II at 389 [A. Tildesley].) Even using those
18 overly conservative assumptions, Mr. Tildesley concluded that APS’ credit ratios
19 remained in the range of published benchmarks for APS’ existing ratings. Ms. Gomez also
20 conducted a worst-case analysis—assuming no debt service by PWEC—and concluded
21 that APS had significant additional debt capacity under present market conditions and that
22 even using the worst-base assumptions, the Company’s credit metrics remained in line
23 with published benchmarks for its current ratings. (B. Gomez Direct Test. at 21-22 and
24 Sch. BMG-3.) Moreover, while APS does have to refinance existing debt in the future, its
25 capital spending during the term of the PWEC loan can be met entirely from internally
26 generated funds (B. Gomez Rebuttal Test. at 10.), and thus no additional incremental APS

1 financing is anticipated over the relatively short period of the APS loan to PWEC. Again,
2 these facts and analysis show that approving the Application will neither impair APS'
3 fundamental utility credit quality nor will it impair APS' ability to provide adequate utility
4 service to its customers.

5 Finally, Staff Condition No. 6, which would exclude in any future rate case
6 consideration of any demonstrable increase in APS' cost of capital attributable to the \$500
7 million financing, ensures that APS customers are held harmless from any of the adverse
8 financial impacts hypothesized by the merchant intervenors. However, if the Application
9 is not approved and if a resulting downgrade of PWCC adversely affects APS, as APS
10 fears based on the available evidence, its customers would not be insulated from any
11 resulting higher costs of capital. Thus, using even the most elemental manner of risk
12 management strategy to protect the public interest, that is, a strategy that minimizes the
13 public's exposure to "uninsured" or "unhedged" risks, the Commission should adopt
14 Staff's recommended conditions as discussed herein and approve the Company's
15 Application as being in the public interest.

16
17 **V. APS AND ITS CUSTOMERS WILL BENEFIT FROM APPROVAL OF THE APPLICATION**

18 **A. Approving the Application will Provide Between \$7.5 and \$13.2 Million**
19 **Per Year in Net Interest Income to APS During the Term of the Loan to**
20 **PWEC that Will Be Flowed Through Directly to APS Customers**

21 Staff's Condition No. 4 would require the difference in interest income received by
22 APS from PWEC and interest expense to be deferred as a credit to offset customer rates in
23 the future, with an interest rate on the deferred amount of 6 percent. (J. Thornton Direct
24 Test. at 12.) Assuming the APS to PWEC loan is not called prior to maturity, this spread
25 over the four year period of a loan from APS to PWEC could total between \$30 million
26 and almost \$53 million, plus interest, to be credited to APS customers. (Tr. vol. IV at 907,

1 980 [J. Thornton].) Given that APS customers are protected from any investment risks
2 associated with the loan, this deferred credit is unquestionably a significant benefit to APS
3 customers that results only from approval of the Application. (See Tr. vol. IV at 992 [J.
4 Thornton].)

5 **B. Approving the Application Results in Significant Narrowing of Track A**
6 **Litigation Issues**

7 APS agrees with Staff that the Principles of Resolution are not directly related to
8 the fundamental merits of the Application. However, the Principles of Resolution, like the
9 Application, are part of the effort undertaken by the Company to address the results of the
10 Commission's Track A decision. And if the Application is approved, even with Staff's
11 proposed conditions, the Principles of Resolution would resolve much of the outstanding
12 litigation resulting from the Track A decision. Moreover, the Principles of Resolution
13 would allow the Commission to first decide the outcome of those few unresolved issues
14 that would remain in the Track A appeals. The resolution of issues through compromise
15 and settlement is unquestionably in the public interest, *see, e.g., Hartford Accident &*
16 *Indem. Co. v. Aetna Cas. & Sur. Co.*, 164 Ariz. 286, 290, 792 P.2d 749 (1990), and further
17 supports approval of the Application.

18 **C. APS Will Benefit from the Financial Community's Positive Assessment**
19 **of this Commission's Regulatory Responsiveness to the Fall Out from**
20 **Decision No. 65154**

21 In addition to the more specific debt ratings assigned by Moody's, S&P and Fitch,
22 the actions of regulators and the regulatory environment in which utilities operate are
23 increasingly significant to the financial well-being of regulated utilities. Mr. Tildesley
24 testified that supportive action from the Commission in addressing this Application would
25 be viewed positively by financial market participants that would help offset uncertainty
26 resulting from the Track A decision. (A. Tildesley Direct Test. at 11.) This is often
referred to as the "halo effect." Ms. Gomez concurred with that assessment and explained

1 that if the Commission did not act positively on the Company's Application, particularly
2 when it could do so with minimal impact to APS, it would likely be "very negatively
3 received." (B. Gomez Direct Test. at 12.) Thus, Ms. Gomez expressed her concern that
4 higher capital costs to APS could ultimately result from a denial of the Application due to
5 financial community concerns over the regulatory environment in Arizona. (*See id.*)

6 Mr. Davis also explained on cross-examination how regulatory responsiveness will
7 likely be well received in the financial community:

8 Q. How are Pinnacle West Capital Corporation and Pinnacle West
9 Energy Corporations' interests related to a responsive and responsible
10 regulatory environment?

11 A. In this particular situation, ... the rating agencies and the financial
12 analysts look at the Settlement that was created in 1999 [as] sort of a
13 package, and now they see that the package has been undone some, and
14 quite frankly, they probably understand why it's been undone some. So
15 they're trying to see now ... how those additional steps will be handled in
16 sort of undoing the 1999 package.

17 (Tr. vol. II at 436-37 [J. Davis].) Therefore, the Commission's approval of the Application
18 will undoubtedly benefit APS and its customers in showing continued regulatory
19 responsiveness to the financial community and thereby minimizing regulatory risk
20 premiums paid by APS. In fact, ratings agencies have specifically noted the existence of
21 regulatory uncertainty concerning PWCC liquidity as a negative factor that could at least
22 be partially addressed by granting the requested financing authority. For example,
23 Moody's wrote:

24 PWCC faces refinancing risk, particularly in 2003, when approximately
25 \$500 million of holding company debt is due. ACC approval of the below
26 outlined financing application should help address this financing concern at
the parent.

(APS Exh. 5.)

1 **D. Approving the Application Preserves the Ability of the Commission to**
2 **Consider Rate Base Treatment of the PWEC Reliability Assets in the**
3 **Company's Next Rate Case**

4 APS has stated that it intends to ask the Commission to ratebase the PWEC
5 reliability assets in the Company's upcoming general rate case. The Residential Utility
6 Consumer's Office also supports ratebasing the PWEC reliability assets, and believes that
7 APS should acquire these assets. (M. Diaz-Cortez Direct Test. at 12.) The Company
8 recognizes that the Commission will have to reach its own conclusion as to whether the
9 PWEC reliability assets should be ratebased after considering the Company's case and all
10 of the relevant evidence. Approving the Application in no way prejudices the
11 Commission's ultimate ratebasing determination regarding any or all of the PWEC
12 Arizona generation. However, if the Commission denies the Application, PWCC and
13 PWEC would be placed in a "desperate" situation and may have to consider selling the
14 PWEC assets to raise cash. (Tr. vol. I at 227 [B. Gomez].) If the assets are sold or
15 otherwise encumbered in an attempt to remove PWCC and PWEC from financial
16 extremis, the Commission would most likely lose the ability to even consider whether or
17 not these assets should remain dedicated to APS customers. (*Id.*) Thus, if the Application
18 is denied, the Commission's ultimate determination on ratebasing the assets likely would
19 be prejudiced—perhaps foreclosed altogether. (*See id.*) The risk of such a prejudicial
20 outcome compared with the lack of risk associated with the Application again is a
21 powerful argument for its approval by the Commission.

22 **E. Approval of the Application Will Not Adversely Affect Track B and**
23 **Retains PWEC as a Viable Competitor for APS Load**

24 The Company's President, Jack Davis, confirmed that approving the Application
25 would not have an adverse impact on the Track B proceeding. (Tr. vol. II at 415-416 [J.
26 Davis].) And, as it relates to APS customers, approval of the Application will allow
PWEC to continue as a viable competitor in Track B. (Tr. vol. II at 437 [J. Davis]; J.

1 Davis Rebuttal Test. at 4.) The presence of an additional wholesale supplier in that Track
2 B proceeding, particularly one owning local generation inside the Phoenix transmission
3 constraint, will undoubtedly benefit APS customers. No party provided evidence (much
4 less a witness) that the approval of the Application would adversely affect the competitive
5 procurement process ongoing in the Commission's Track B proceeding.⁶

6 **F. Approval of the Application with the Staff Conditions May Result in**
7 **Greater Regulatory Insulation for APS Within the Holding Company**
8 **Structure**

9 Although APS already follows a conservative dividend policy, Staff witness
10 Thornton testified that Staff's proposed Condition No. 7 provides important and
11 meaningful regulatory insulation of APS. (*See* APS Exh. 6 [Moody's Sept. 9, 2002
12 Opinion Update]; *see also* J. Thornton Direct Test. at 12-13.) To the extent that rating
13 agencies agree with Mr. Thornton as to the need for these explicit forms of limitations on
14 inter-affiliate transfers of funds, this condition could result in additional credit support for
15 APS down the road. Although APS believes that the dividend policy of APS is entrusted
16 by law to the prudent business judgement of the APS Board of Directors, it has voluntarily
17 agreed to accept Staff's Condition No. 7 in conjunction with approval of its Application
18 subject to the Staff conditions, as are discussed herein. (J. Davis Rebuttal Test. at 9-10; B.
19 Gomez Rebuttal Test. at 6.)
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23 ⁶ Through its cross-examination, Panda criticized Staff for not conducting an analysis of whether
24 approval of the Application would affect wholesale power prices. However, Panda never presented a
25 witness or evidence regarding how approval of the Application could affect power prices to the detriment
26 of APS customers, nor would Panda even offer an explanation when asked. (*See* Tr. vol. IV at 957 [J.
Thornton].) Mr. Thornton confirmed, however, that he had not seen any evidence that approval of the
Application would result in higher power prices nor could he think of any reason why that outcome would
occur. (Tr. vol. IV at 995-96 [J. Thornton].)

1 VI. THE APPLICATION IS CONSISTENT WITH AND MEETS THE
2 STATUTORY REQUIREMENTS OF A.R.S. § 40-301, *ET SEQ.*, AND A.A.C.
R14-2-804 OR R14-2-806

3 A. “Lawful Purposes”

4 A.R.S. § 40-301(C) provides that the Commission must find that a proposed
5 financing is for a “lawful purpose.” There is no statutory limitation on the phrase “lawful
6 purpose” in Title 40. Thus, this provision must be presumed to mean what it says—that
7 the Commission must find that the purpose is one that not unlawful. *See* A.R.S. § 1-213
8 (“Words and phrases shall be construed according to the common and approved use of the
9 language.”) In this case, there is no legal prohibition on APS borrowing or loaning money
10 to an affiliate or any other party, provided that the Commission approves such a
11 transaction in the case of an affiliate to the extent required by Commission orders and
12 regulations. No party has argued or presented evidence to show that the financing is in any
13 way unlawful.

14 B. “Within Corporate Powers”

15 This issue is very closely related to the first. In that respect, the Chief
16 Administrative Law Judge took administrative notice of APS’ Articles of Incorporation.
17 (Tr. vol. II at 452.) Those Articles provide, in part, that “the purposes for which [APS] is
18 organized include the transaction of any or all lawful business for which corporations may
19 be incorporated under Chapter 1 to Title 10, Arizona Revised Statutes....” A.R.S. § 10-
20 301 provides that “[s]ubject to any limitations or requirements contained in the articles of
21 incorporation or in any other applicable law, a corporation shall have the purpose of
22 engaging in and may engage in any lawful activity.” *See also* A.R.S. § 10-302 (providing
23 that every corporation has the power to pledge property make contracts, incur liabilities,
24 borrow and lend monies, and issue notes, bonds or other obligations). As discussed in
25 Section VI.A, above, the financing is in no way unlawful. Therefore, the financing is
26 clearly within the corporate powers of APS.

1 **C. “Compatible with the Public Interest”**

2 There is no specific definition of the term “public interest” in A.R.S. § 40-301(C).
3 There is also no specific judicial authority on this term in Arizona. The New Hampshire
4 Supreme Court, however, addressed the meaning of the term “public good” in a New
5 Hampshire statute that required a commission finding that a requested utility financing
6 “be consistent with the public good.” *See Appeal of Roger Easton*, 480 A.2d 88, 90-91
7 (N.H. 1984). In a controversial financing involving a nuclear power plant, the New
8 Hampshire court noted that a utility company “does not surrender its right to manage its
9 own affairs merely by devoting its private business to a public use.” *Id.* at 90. It then held
10 that “consistent with the public good” meant that “a proposed action must be one not
11 forbidden by law, and that it must be a thing reasonably to be permitted under all the
12 circumstances of the case.” *Id.* at 91 (citing *Grafton County Elec. Light & Power Co. v.*
13 *State*, 94 A. 193 (N.H. 1915)). The court went on to hold that “it is not for the public good
14 that public utilities be unreasonably restrained of liberty of action, or unreasonably denied
15 the rights as corporations which are given to corporations not engaged in service to the
16 public.” (*Id.*)

17 In this case and considering all the circumstances, granting the Application is
18 compatible with the public interest. It will protect the credit ratings of both PWCC and
19 APS, without significantly affecting APS’ fundamental utility credit quality and without
20 risk to APS customers. It will demonstrate regulatory responsiveness to the financial
21 community by providing a tangible example of how the Commission will address the
22 fallout from the Track A decision. Staff’s conditions will increase regulatory insulation
23 between APS and PWCC, and provide that APS voluntarily limit dividends to maintain a
24 minimum equity ratio. It will preserve the Commission’s ability to consider ratebasing the
25 PWEC reliability assets in the future and preserve PWEC as a viable competitor in
26 Arizona’s wholesale electric market. It will result in the resolution of significant litigation

1 resulting from the Track A decision. It provides APS customers assurance of up to \$53
2 million (excluding interest) in future rate benefits. And it will not adversely affect
3 competitive bidding in Track B. Any one of these facts would make the financing
4 compatible with the public interest; collectively, these facts make such a determination all
5 the more clear.

6 **D. "Sound Financial Practices"**

7 A public service corporation financing must also be compatible with "sound
8 financial practices." The financing requested in the Application will avoid a potential
9 downgrading of PWCC, and any resulting adverse financial impacts on APS. Taking
10 action to avoid such adverse consequences is unquestionably sound financial practice.
11 Further, as discussed above, the financing is not expected to impair APS fundamental
12 utility credit quality. (*See* Section IV.C, *supra*.) APS can also fund capital expenditures
13 from internally-generated funds and will still retain significant additional bonding
14 capacity. (B. Gomez Rebuttal Test. at 8-10.) Additionally, although she opposed the
15 Application for other reasons, Panda witness Abbott herself acknowledged that it was
16 "perfectly reasonable" from an investment perspective for APS to loan money to PWCC.
17 (Tr. vol. III at 765 [S. Abbott].) Thus, the record shows that the financing is consistent
18 with sound financial practices.

19 **E. "Proper Performance" ... "of Service as a Public Service Corporation
20 and will not Impair its Ability to Perform that Service"**

21 Again, there is no Arizona judicial precedent defining compatible with the proper
22 performance of service as a public service corporation. Clearly, the protection of APS'
23 creditworthiness should PWCC be downgraded is compatible with such a purpose. (Tr.
24 vol. IV at 1000 [J. Thornton].) Protection of assets used to serve APS customers, and the
25 preservation of the Commission's ability to consider ratebasing these PWEC reliability
26 assets in the future, as well as maintaining PWEC as a viable competitor in the Track B

1 proceeding are also compatible with the proper performance of APS' service. (B. Gomez
2 Rebuttal Test. at 9.) And, the evidence shows that APS' credit metrics, even using worst-
3 case assumptions, are not adversely affected and APS will continue to meet its obligation
4 to serve. (See B. Gomez Rebuttal Test. at 8-10; A. Tildesley Direct Test. at 9; see also
5 Section IV.C, *supra*.)
6

7 VII. STAFF'S PROPOSED CONDITIONS

8 A. Staff's Seven Proposed Conditions

9 Staff witness John Thornton, in concluding that the APS Financing Application
10 should be granted, proposed that the Commission adopt the following seven conditions:

- 11 1. Limit the amount of debt that APS may issue to \$500 million
12 in addition to its current authorizations;
- 13 2. Require the note from APS to PWEC to be callable and
14 secured in the same manner as required by the Commission in
15 Decision No. 65434;
- 16 3. Impose on the PWEC note a premium of 264 basis points
17 over an APS secured note for an equivalent term;
- 18 4. Record as a deferred credit, bearing 6% interest, the
19 difference between the PWEC note's interest income to APS
20 and the hypothetical interest expense incurred by APS, and
21 reflect that deferred credit in the next APS rate case;
- 22 5. Limit the PWEC note to no more than four years, unless
23 Commission approval is granted for a longer term;
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6. Exclude from any future APS rate case any demonstrable increase in the APS cost of capital attributable to the transaction between APS and PWEC; and
7. Require APS to maintain a minimum equity ratio of 40% and preclude APS from paying a dividend without Commission approval if APS' common equity ratio would be reduced below that threshold, unless otherwise waived by the Commission. The Commission would rule upon any APS requests within 60 days, during which time the dividend limitation would be suspended.

As APS indicated in its filed testimony and during the hearing, APS accepts in principle each of Staff's conditions if the Commission otherwise approves APS' Application without further modification. (B. Gomez Rebuttal Test. at 4.) However, APS requests that the Commission modify one aspect of and make one clarification to those conditions.

B. APS' Proposed Modifications to and Clarification of Staff Conditions

1. Staff Condition No. 3

APS generally accepts the concept of charging PWEC or PWCC a premium for the loan from APS. But it firmly believes that the premium proposed by Staff is excessive because the proposed 264 basis point spread substantially overstates the risk undertaken by APS, particularly in light of the other conditions recommended by Mr. Thornton. Most specifically, PWEC is asked to pay a risk premium for the benefit of APS customers, but as a result of Staff Condition No. 6, APS customers assume none of the risk for which they are to be compensated. (Tr. vol. IV at 992 [J. Thornton].) As APS noted in its prefiled testimony and during the hearing, a 150 basis point spread would more correctly correspond to difference between APS' credit rating and that rating PWEC would have

1 obtained absent Decision No. 65154. (B. Gomez Rebuttal Test. at 5; Tr. vol. I at 102-04.)
2 It also would reflect the appropriate spread if the loan were made directly to PWCC
3 (rather than to PWEC and then passed as a dividend up to PWCC), an option requested in
4 the Application but rejected by Staff.

5 **2. Staff Condition No. 7**

6 APS proposes that the Commission adopt the clarification to Staff Condition No. 7
7 set out by APS Witness Barbara Gomez and agreed to by Staff Witness John Thornton
8 during the hearing. APS would calculate the equity ratio on a quarterly basis, using APS'
9 10-Q or 10-K filings with the Securities and Exchange Commission ("SEC"). Using the
10 reported APS balance sheet accounts, APS would divide the APS common equity by the
11 sum of such common equity and APS long-term debt (including current maturities of such
12 debt). (Tr. vol. IV at 907 [J. Thornton]; B. Gomez Rebuttal Test. at 6.) Defining the
13 calculation now will avoid possible future uncertainty surrounding the ability of APS to
14 declare dividends in the future. (B. Gomez Rebuttal Test. at 6.)
15

16 **VIII. LOAN VERSUS GUARANTEE**

17 An issue of much discussion during the hearing was whether APS should be
18 limited to guaranteeing the debt of PWEC or should instead be permitted to issue its own
19 debt and loan the proceeds to PWCC or PWEC (or have the option to do either or both).
20 In its Application, APS sought approval to both (i) issue debt in the amount of \$500
21 million to lend the proceeds to PWCC or PWEC and (ii) guarantee debt of PWCC or
22 PWEC in an amount up to \$500 million, and to have such approval granted before the end
23 of 2002. APS initially requested the approval of both options to ensure that it would have
24 the flexibility to implement the best financing plan. Staff rejected the guarantee option, as
25 well as the option of APS loaning money to PWCC, and indicated that the only option it
26

1 would presently support (and only with the proposed seven conditions) was the issuance
2 of APS debt, the proceeds of which APS would then loan directly to PWEC.

3 Although APS initially sought approval to pursue both options, APS (if forced to
4 choose one over the other) now prefers the loan option, primarily because of the
5 anticipated timing of the final order in this proceeding. Because the financial markets are
6 more familiar with APS debt, it will be easier and therefore quicker to obtain the needed
7 funds than if potential lenders must do "market discovery" on PWEC. (Tr. vol. II at 292-
8 93 [B. Gomez]; A. Tildesley Direct Test. at 8-9.) This will especially be true if it is
9 determined that PWEC should register its debt with the SEC as an initial public offering
10 rather than place the debt privately. The initial PWCC bridge debt comes due in July of
11 2003, which means that the debt must be refinanced by that time. Because the final
12 Commission order in this proceeding cannot be anticipated before early March, and it will
13 take longer to put the guarantee in place, APS is concerned that it may not be able to
14 secure the more complex guarantee in time.

15 Moreover, certain of Staff's conditions would be difficult to implement with a
16 guarantee. (Tr. vol. II at 295 [B. Gomez].) For example, it likely would be difficult to
17 limit the PWEC debt to four years or to make PWEC debt of any maturity callable. In
18 addition, it is not clear how Staff's proposed security interest structure would work in the
19 context of a guarantee. (*Id.*) In addition, because the financial community is more familiar
20 with APS, a loan obtained by APS will be less costly overall. A guarantee will require
21 more documentation and could very well require a structure premium that would not be
22 required for the loan. (Tr. vol. II at 293 [B. Gomez].) And, finally, an APS loan to PWEC
23 reduces future issues involved in the determination by the Commission of the ultimate
24 rate-making treatment of the PWEC dedicated units because it minimizes any subsequent
25 costs of assuming or refunding the PWEC debt being guaranteed by APS. (Tr. vol. II at
26 292-93 [B. Gomez]; Tr. vol. IV at 896 [M. Diaz-Cortez].)

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IX. CONCLUSION

This case is not about assigning individual or collective “blame” for the clear and present liquidity crisis. The more pressing question is where we go from here to complete the unfinished work from Decision No. 65154. APS and Staff, along with representatives of both investors and consumers, have proposed a prudent and responsible plan that combines both safeguards to and benefits for APS consumers. The “just say no” parties offer neither safeguards nor tangible benefits. APS urges the Commission to act quickly to grant its Application subject to the Staff conditions as discussed herein.

RESPECTFULLY SUBMITTED this 27th day of January 2003.

SNELL & WILMER L.L.P.


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10 All parties of record

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