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ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission
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OCT 24 2002

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October 21, 2002

Chairman William Mundell
Commissioner Marc Spitzer
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: *Arizona Public Service ("APS") Motion for Expedited Review of its Financing Application (E-01345A-02-0707)*

Dear Fellow Commissioners:

I read your letters regarding the above-referenced matter, as well as the various pleadings that have been filed relating to this issue. In addition, I read the recent Standard & Poors release relating to Pinnacle West and its belief that there is reason to support maintaining its current credit rating. There is no doubt that resolution of this issue as soon as possible is of great importance and that it must be done in such a matter that assures that it receives the thoughtful and comprehensive review it requires.

Like Chairman Mundell, I am hesitant to expedite this matter in such a way that would prevent the careful and deliberate process that an application of this nature requires. Although I am very aware of the Commission's stated objective to review this matter as quickly possible, I am also aware that this application is not "traditional" and raises issues that were not necessarily contemplated when resolving the Track A issues. The inclusion of APS's assets mandates an analysis to determine its effects on rate payers and the possible risks it may pose to them.

In addition, Pinnacle West Capital's ("Pinnacle") financial condition is not as precarious as may have previously been thought, and the recent analysis performed by Merrill Lynch (attached to Chairman Mundell's letter) as well as the recent upgrade to "equal weight" made by Lehman Brothers (see attached) appear to confirm that. When addressing the possibility that the financing application is not approved, Lehman Brothers states,

> "While an adverse outcome on the financing order could result in an equity offering and move the stock lower on liquidity events, we believe that the worst case scenario is a low probability <u>and the current stock price adequately discounts such a risk</u>."

Thus, at this time, I find it unnecessary to significantly accelerate this application to any greater degree. However, I also believe that there is the potential to shorten the schedule to some extent and bring this matter before the Commission sooner than currently scheduled. As such, I would support the ALJ's revisiting the current schedule in an attempt to "shave off" as many days as possible if it can be done without compromising the integrity of the proceedings.

Sincerely,

Jim Irvin
Commissioner

Attachment

Cc: All parties of record

LEHMAN BROTHERS
EQUITY RESEARCH

October 21, 2002

United States
Energy & Power
Power & Utilities

Pinnacle West Capital (PNW - $25.51) 2-Equal weight

Recommendation Change

Waiting on the ACC

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Investment conclusion

- Raising PNW to 2-Equal Weight as worst case fundamental valuation reflected at $25/share.

Summary

- We are raising PNW to Equal Weight from Under Weight as we believe the fundamental worst-case is reflected at $25/share. Our worst case scenario includes a $500mil equity offering should the ACC fail to grant the financing order and therefore such a liquidity event could move the stock below the $25 fair value estimate.
- Based on the recent analyst meeting and ACC commentary, we believe the financing order is likely granted and therefore we believe the worst case scenario is a low probability event. In a worst case, we see post GRC EPS power of $2.70 with a base case producing $3.45 of EPS power and best case producing $4.15 of EPS.
- Our $28 price target reflects a 15% discount to the sector average on our 2004 base case EPS estimate of $3.45. Our discount valuation reflects the regulatory/liquidity uncertainty surrounding the financing order and the Track B issues.

Stock Rating:		**Target:**	
New:	2-Equal weight	New:	28.00
Old:	3-Underweight	Old:	34.00

Sector View: 3-Negative

EPS (FY Dec)

	2001	2002			2003			% Change	
	Actual	Old	New	St. Est	Old	New	St. Est	2002	2003
1Q	0.73	0.63A	0.63A	0.63A	NA	NA	0.00E	(14)	NA
2Q	0.79	0.89A	0.89A	0.89A	NA	NA	0.00E	13	NA
3Q	1.91	NA	NA	1.45E	NA	NA	0.00E	NA	NA
4Q	0.57	NA	NA	0.52E	NA	NA	0.00E	NA	NA
Year	4.00	3.50E	3.50E	3.45E	4.00E	3.25E	3.65E	(13)	(7)
P/E			7.3			7.8			

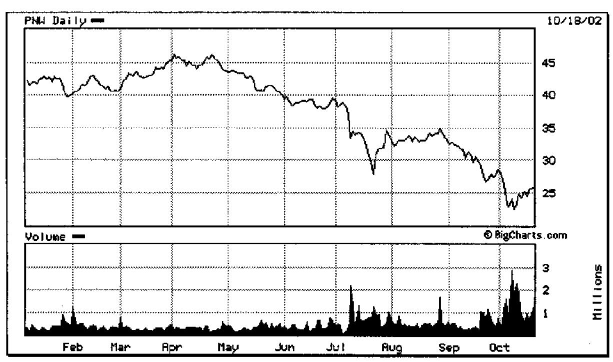
Market Data

Market Cap	2168.4M
Shares Outstanding (Mil)	85.0
Float	NA
Dividend Yield	6.2%
Convertible	NA
52 wk Range	46.68 - 21.70

Financial Summary

Revenue FY02	NA
Five-Year EPS CAGR	5%
Return on Equity	11.25%
Current BVPS	$30.00
Debt To Capital	60%

Stock Overview



Risks Adequately Reflected

We are upgrading shares of PNW to Equal Weight from Under Weight as we believe the fundamental worst case scenario is reflected at $25/share. While an adverse outcome on the financing order could result in an equity offering and move the stock lower on liquidity events, we believe the worst case scenario is a low probability event and the current stock price adequately discounts such risk. Further, the 7% yield should be safe due to the low payout ratio on the likely raised $1.70 dividend level.

We are lowering our 2003 EPS estimate to $3.25 from $4.00 to reflect cost pressures from out of market gas hedges and higher power costs which combined pressure EPS by approximately $0.70/share. That said, our rating and valuation framework has been and will continue to be focused on the 2004/2005 EPS power of PNW as the 2003/2004 General Rate Case will reset the earnings power of APS and PWEC which are the dominant earnings drivers over the long-term.

Scenario Analysis

PNW faces several regulatory decisions over the coming 2 years which will have a material impact on the company's EPS power and therefore longer-term valuation. As a result of the regulatory moving parts, we have evaluated the company with a scenario analysis and concluded the worst case scenario is adequately reflected in the current share price. The following is the construct of our scenario analysis:

Base Case ($3.45 of EPS power): In the base case scenario, we have assumed the financing order is granted by the ACC and therefore the parent level liquidity risk is removed. Thereafter, we have assumed the company obtains rate base recovery of West Phoenix 4 &5 ($350 million) and the remaining $650 million of assets (Redhawk 1 & 2) do not receive rate base recovery but rather earn a 5% pretax return in the competitive markets. Further we have assumed the $4.4 billion APS rate base receives a n 11.25% ROE on a 43% equity ratio. Finally, we have assumed zero contribution for M&T, $10mil net for Suncor and $5 million for APS Energy Services. The basis for our PWEC ratebasing assumption is that West Phoenix 4&5 are situated closer to the load center and were clearly built for APS load only. While it is possible the Redhawk units could be placed in ratebase, these units are difficult to differentiate from other CCGT assets located near the Palo Verde hub.

Worst Case ($2.70 of EPS power): In the worst case scenario, we have assumed the ACC fails to provide the financing order and the company is forced to issue $500 million of equity to extinguish the parent debt and preserve the credit rating of the company. Further, we assume the company does not rate base any of the $1 billion of PWEC generation and earns a 5% pretax return on the assets. Again we have assumed the $4.4 billion APS rate base earns an 11.25% ROE on a 45% equity ratio (higher due to the lack of debt transfer to APS), zero contribution from M&T, $10mil net for Suncor and $5 mil for APS Energy Services. We believe this should represent the worst of worst case scenarios as PNW management indicated an equity offering would be pursued as a last alternative with capex reductions, accelerated asset sales and debt offerings as potential sources of liquidity. Based on recent commentary from Cmsr Spitzer and Mundell as well as commentary made at the Aug 27th ACC meeting, we believe denial of the financing order is a low probability event.

Best Case ($4.15 of EPS power): In the best case scenario, we have assumed the ACC grants the financing order and the company receives rate base recovery for the $1 billion of PWEC assets. Under this scenario the new APS (old APS + PWEC generation) would earn an 11.25% ROE on a 45% equity ratio. In our best case we have assumed zero contribution from M&T, $40million net from Suncor and $10 mil net from APS Energy Services.

Suncor Strategy and EPS treatment

At the analyst meeting, PNW management indicated Suncor (real estate business) would see an accelerated liquidation process in the 2002-2005 timeframe. While Suncor has traditionally been an asset harvesting business that provided steady EPS and cash flow to the parent, PNW is looking to accelerate the pace of the harvest to enhance liquidity. Specifically Suncor is expected to contribute $20 million net in 2002 versus $3.3 million in 2001. Thereafter, PNW expects Suncor EPS contributions to double by 2005 from 2002 levels and produce annual free cash of $80-100 million to the parent. We have included a lower level ($10mil net) in our base and worst case estimates as this represents historical levels and we don't wish to include the higher levels as they will likely peak at $0.47/share in 2005 and then drop away as the Suncor liquidation nears completion in 2005/2006. We believe the company will likely receive slightly better than the approximate $300 million of book equity value at Suncor.

ACC Process

PNW and APS are in the midst of several critical regulatory decisions that will significantly impact the company's future. The primary regulatory events are : 1) Track A -dealing with asset transfers; 2) Track B - dealing with the competitive bidding process; 3) the financing order and 4) the General Rate Case or (GRC).

Track A- The ACC has decided that APS may not transfer utility generation to PWEC as was required in the 1999 regulatory settlement. APS filed a motion for reconsideration on this issue and was denied on Oct. 17th. The company can continue the appeals process in the courts if they so desire. As a result of this decision, PNW will likely be moving PWEC generation assets into APS with a resulting larger utility and the level of new rate base determined through a prudency review in the 2003 GRC.

Track B- The ACC initial staff report has indicated the company will competitively bid the generation required to serve native load that is not supplied by APS generation and pre-existing purchase power contracts. Further the staff report indicated the PWEC generation (1790MW) will not be included in the APS generation and therefore will be competitively bidding against other merchants. The company's peak demand with a mid teens reserve margin is approx 6600MW with APS generation at 4000MW and pp contracts at 800MW. Therefore, APS will conduct a competitive bid for 1800MW at a 20-25% load factor (summer peak) beginning summer 2003.

A final staff report is anticipated Oct 25th and is not expected to differ from the original draft report. On Nov 4th, APS will file the amount of contestable load and the process to obtain the power. Thereafter, parties will file comments on the staff report on Nov 12th with a formal hearing beginning on Nov 21st. We would not expect the process to be finalized until early 2003 for competitive bidding on summer 2003 peak load.

Financing Order - As a result of the Track A decision, APS and PNW are seeking a $500 million financing order from the ACC. The financing order will allow the PWEC generation assets (1800MW at West Phoenix and Redhawk) to be financed on the balance sheet of the utility or with the credit support of the utility assets. Based on recent commentary from ACC Cmsr's and the ACC reversal on the electric competition rules and 99 settlement, we believe it likely they will grant the financing order to the company. The key on this order will be timing as the current hearing is set to begin January 8th and therefore would involve 2-3 new commissioners out of a total of 5 commissioners created by the Nov elections. Based on recent ACC commentary, it appears a December hearing is quite possible and therefore a decision from the existing 3 member ACC can be accomplished.

General Rate Case- APS is required to file a GRC by June 2003 that will reset base rates for the 2004/2005 period depending when the rate case is finalized. In addition to seeking recovery on existing utility assets, APS will be pursuing recovery of stranded costs written off during the 99 regulatory settlement and all or a portion of the 1790MW of PWEC generation the company is seeking to finance at the APS level. As described above, we are assuming the company will be granted an ROE and capital structure fairly similar to the last rate case which produced an 11.25% ROE on a 43% equity ratio. We are assuming a traditional rate formula in our EPS power estimates, but recognize that APS traditionally has reached settlements that allow the company to earn beyond the set ROE levels. Finally, we have assumed the existing EPS favorable regulatory asset amortization in the 99 settlement agreement remains intact.

Financial Health

Outside of the unlikely short-term ACC liquidity driven event at the parent level, we see a financially healthy PNW. The company's peak leverage of 60% will occur in late 2002 as the PWEC construction cycle nears an end. Thereafter, debt/total cap should decline by approximately 1.5% annually as the company moves toward the targeted 55% debt/total cap. Cash flow to Debt metrics remain strong with 6X ebitda/interest coverage and 3X total debt/ebitda. The company's leverage will decline as a function of high retained earnings driven by the low payout ratio, rather than FCF driven debt reduction. Excluding Suncor asset sales, we don't see free cash flow generation (after capex and divs) until the 2004/2005 timeframe. That said the cancellation or deferral of the Silverhawk project could reduce capex sufficiently to move the company to FCF positive in 2004.

Investment Outlook

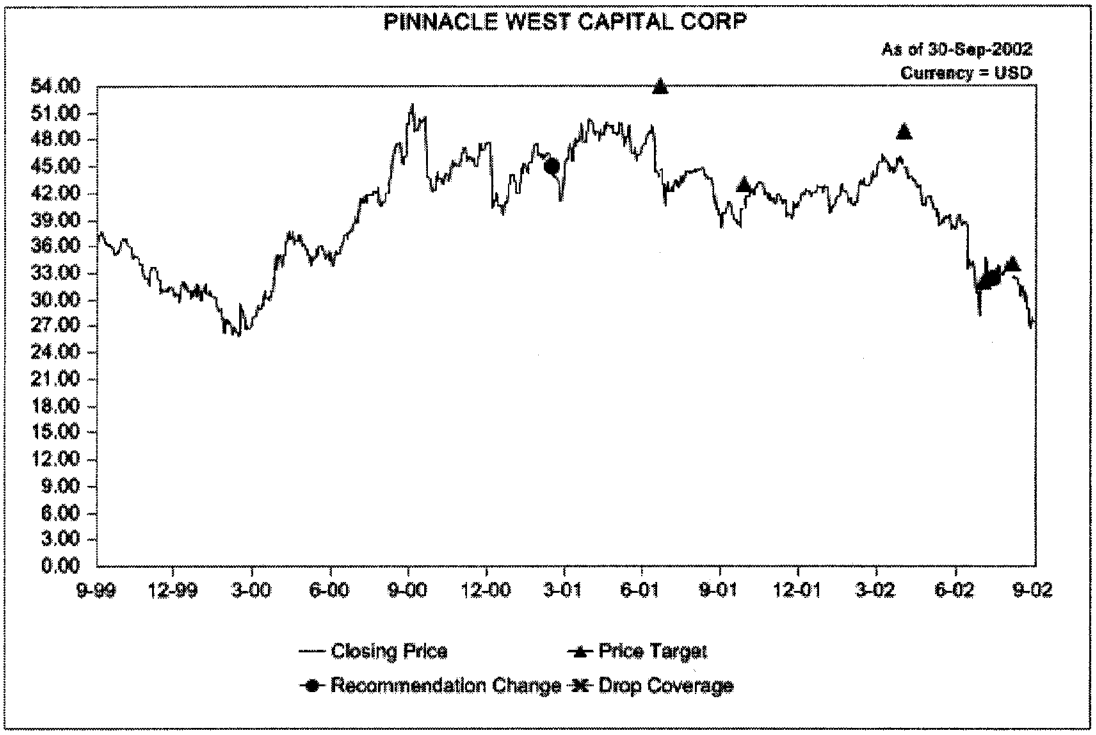
We are raising our rating to Equal Weight from Under Weight with a $28 price target. Our price target reflects a 15% discount to 2004 sector average multiples on our base case estimate of $3.45. As we believe PNW is among the best managed companies, the discount valuation reflects the regulatory/financial uncertainty created by a difficult and inconsistent regulatory environment. Historically, PNW has emerged from the ACC with shareholder friendly reg outcomes, but the process has normally proven unpleasant and we expect much the same during the current regulatory rounds. Longer-term, we see above average growth potential from one of the fastest growing regions in the nation and balance sheet improvement.

Company Description:

Company Name:	**Disclosures***	**Ticker**	**Price (10/18)**	**Rating**
Pinnacle West Capital	X	PNW	25.51	2-Equal weight

***PLEASE SEE DISCLOSURE LEGEND ON THE LAST PAGE**

Rating and Price Target Chart: PNW



Date	Closing Price	Rating	Price Target
28-Aug-02	$34.05		$34.00
05-Aug-02	$32.39	3-Underweight	
26-Jul-02	$31.90		$32.00
25-Apr-02	$45.28		$49.00

Date	Closing Price	Rating	Price Target
22-Oct-01	$40.15		$43.00
17-Jul-01	$43.86		$54.00
13-Mar-01	$45.10	3-Market Perform	

FOR EXPLANATION OF RATINGS PLEASE REFER TO THE STOCK RATING KEYS LOCATED AT THE END OF THIS DOCUMENT

Important Disclosures:
The analysts responsible for preparing this report have received compensation based upon various factors including the Firm's total revenues, a portion of which is generated by investment banking activities.

Risk Disclosure:
PNW: Key risks are commodity prices, refinancing and interest rate risk, credit risks, Arizona state and Federal regulation.

Key to Investment Opinions:

Stock Rating
1-Overweight - The stock is expected to outperform the unweighted expected total return of the industry sector over a 12-month investment horizon.
2-Equal weight - The stock is expected to perform in line with the unweighted expected total return of the industry sector over a 12-month investment horizon.
3-Underweight - The stock is expected to underperform the unweighted expected total return of the industry sector over a 12-month investment horizon.
RS-Rating Suspended - The rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Lehman Brothers is acting in an advisory capacity on a merger or strategic transaction involving the company.

Sector View
1-Positive - sector fundamentals/valuations are improving.
2-Neutral - sector fundamentals/valuations are steady, neither improving nor deteriorating.
3-Negative - sector fundamentals/valuations are deteriorating.

Stock Ratings From February 2001 to August 5, 2002 (sector view did not exist):
This is a guide to expected total return (price performance plus dividend) relative to the total return of the stock's local market over the next 12 months.
1-Strong Buy - expected to outperform the market by 15 or more percentage points.
2-Buy - expected to outperform the market by 5-15 percentage points.
3-Market Perform - expected to perform in line with the market, plus or minus 5 percentage points.
4-Market Underperform - expected to underperform the market by 5-15 percentage points.
5-Sell - expected to underperform the market by 15 or more percentage points.

Stock Ratings Prior to February 2001 (sector view did not exist):
1-Buy - expected to outperform the market by 15 or more percentage points.
2-Outperform - expected to outperform the market by 5-15 percentage points.
3-Neutral - expected to perform in line with the market, plus or minus 5 percentage points.
4-Underperform - expected to underperform the market by 5-15 percentage points.
5-Sell - expected to underperform the market by 15 or more percentage points.
V-Venture – return over multiyear timeframe consistent with venture capital; should only be held in a well diversified portfolio.

Distribution of Ratings:
Lehman Brothers Equity Research has 1491 companies under coverage.
32% have been assigned a 1-Overweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Buy rating, 28% of companies with this rating are investment banking clients of the Firm.
41% have been assigned a 2-Equal weight rating which, for purposes of mandatory regulatory disclosures, is classified as a Hold rating, 11% of companies with this rating are investment banking clients of the Firm.
27% have been assigned a 3-Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating, 39% of companies with this rating are investment banking clients of the Firm.