



BEFORE THE ARIZONA CORPORATION COMMISSION

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2006 APR 24 P 3:39

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IN THE MATTER OF THE APPLICATION OF  
ARIZONA PUBLIC SERVICE COMPANY  
FOR AN EMERGENCY INTERIM RATE  
INCREASE AND FOR AN INTERIM  
AMENDMENT TO DECISION NO. 67744

DOCKET NO. E-01345A-06-0009

EXCEPTIONS OF ARIZONA  
PUBLIC SERVICE COMPANY  
TO RECOMMENDED ORDER

INTRODUCTION AND SUMMARY

Pursuant to A.A.C. R14-3-110(B), Arizona Public Service Company ("APS" or the "Company") hereby submits to the Arizona Corporation Commission ("Commission") its Exceptions to the Recommended Opinion and Order ("Recommended Order" or "R.O.") issued by the Chief Administrative Law Judge ("CALJ") on April 19, 2006.

APS appreciates the recognition by the CALJ that "some action should be taken to insure more timely recovery of APS' prudent fuel and purchased power costs" (R.O. at 23). APS is also cognizant of the Commission's efforts to timely resolve this proceeding. Surely, APS takes no pleasure in having to request price increases for any reason, but in this instance it is not only necessary but the only responsible thing to do given the near certain alternative of having to seek yet higher prices if APS' financial integrity is not maintained and improved.

The above being said, APS respectfully disagrees with the Recommended Order's conclusions that (1) an "emergency" does not exist, (2) an interim 5 mill adjustor (which actually is less than 5 mills) effective May 1, 2006, is sufficient to

1 deal with the emergency that exists, and (3) APS or Pinnacle West Capital  
2 Corporation ("PWCC") should somehow be required to "insure" that its financial  
3 ratios remain investment grade irrespective of circumstances.

4 APS believes that an interim PSA adjustor of at least 9 mills effective May 1,  
5 2006 (added to the existing 4 mill PSA adjustor) is necessary to have a reasonable  
6 level of assurance of preventing a downgrade to "junk."<sup>1</sup> In contrast, the  
7 Recommended Order's use of an inadequate, temporary adjustor mechanism does not  
8 ameliorate the emergency when, as shown below, the proposed adjustment would  
9 leave the Company's unrecovered fuel balance at year-end 2006 in a worse position  
10 than at year-end 2005, would provide only partial and temporary improvement in the  
11 Company's credit metrics to levels still in the "junk" category, and would therefore  
12 continue to place the Company and its customers at substantial risk (possibly as high  
13 as 50%, per APS Exhibit No. 6) that the Company will be downgraded to non-  
14 investment "junk" credit status.

15 **I. THE RECOMMENDED ORDER INCORRECTLY CONCLUDES**  
16 **THAT NO "EMERGENCY" EXISTS.**

17 Although the Recommended Order concedes that under the applicable legal  
18 authorities, the Commission's authority to grant emergency relief "is not limited to  
19 specific, narrowly tailored facts," the Recommended Order incorrectly concludes that  
20 no emergency exists that justifies the relief that APS seeks. (R.O. at 23.)

21 The basis for that incorrect conclusion is the Recommended Order's assertion  
22 that the circumstances presented here can be adequately addressed on a non-  
23 emergency basis through the proposed adjustment to the PSA mechanism. However,  
24 the existence of more than one means to address an emergency does not mean that

25 \_\_\_\_\_  
26 <sup>1</sup> This also assumes that APS' step two surcharge in the amount of \$44.5 million is approved effective as of July 1, 2006.

1 there is no emergency. And as demonstrated above, the 5 mill adjustor that the  
2 Recommended Order proposes fails to address the emergency described by the  
3 witnesses at the hearing and summarized in APS' post-hearing brief. For that reason  
4 alone, the premise of the Recommended Order's reasoning regarding the existence of  
5 an emergency is inaccurate.

6 Moreover, the Recommended Order's legal analysis regarding the existence of  
7 an emergency is flawed as a matter of law. No testimony or evidence adduced at the  
8 hearing contradicted the assertion that, if APS were to be downgraded to "junk"  
9 status, the Company's access to credit would be impaired, short-term borrowing costs  
10 would increase immediately, and the Company and its customers would bear as much  
11 as \$1.2 billion in additional financing costs over the next ten years. Moreover, S&P  
12 and the other rating agencies have made it clear in their public statements that this  
13 interim proceeding figures prominently in their analysis and that unless the  
14 Commission permits the Company "timely and full" relief from its mounting  
15 unrecovered fuel and purchased power costs, the Company faces a significant risk of a  
16 rating downgrade for that reason alone.

17 For these reasons, current conditions clearly fall within the circumstances  
18 described in the relevant cases and the 1971 Attorney General's Opinion as justifying  
19 emergency relief because APS plainly "needs immediate, emergency relief to avoid  
20 serious damage." Op. Att'y Gen. 71-17, at 47. Contrary to the CALJ's remark (R.O.  
21 at 22) that APS has somehow "gotten itself into" this "position," the undisputed  
22 evidence proves that a large portion of the Company's unrecovered fuel and  
23 purchased power cost balance results from Hurricanes Katrina and Rita and other  
24 market forces beyond the control of APS that have caused fuel and purchased power  
25 prices to increase at an unanticipated and virtually unprecedented rate in the last  
26 twelve months. Similarly, the Commission's interpretation of the PSA authorized by

1 Decision No. 67744 in January of 2006 (Decision No. 68437, February 2, 2006),  
2 which would not allow surcharges to be requested prior to the annual reset of the PSA  
3 adjustor, was so at odds with the expectations of APS, the other parties to the APS  
4 Settlement and the financial community as to be the precipitating event of the present  
5 circumstances facing APS. To suggest, as the Recommended Order does, that APS  
6 seeks to “deflect[] responsibility” for the emergency that exists (and for the recent  
7 credit downgrades and the potential for further downgrades) ignores the reality of the  
8 situation that gave rise to this proceeding. Moreover, such statements underscore the  
9 flaws in the Recommended Order’s legal analysis. As APS demonstrated in its Post-  
10 Hearing Memorandum and in the detailed legal memorandum filed prior to the  
11 hearing, one cannot correctly construe the 1971 Attorney General’s Opinion (which is  
12 the only authority cited by the Recommended Order) as narrowly as does the  
13 Recommended Order or as the limit of authority on what constitutes an “emergency.”  
14 The cases both before and after the 1971 Attorney’s General Opinion make it clear  
15 that the financial hardship now faced by APS -- including the potential for downgrade  
16 to “junk” status -- constitutes a sufficient legal basis for declaration of an emergency.  
17 Indeed, prior Commission decisions have so stated. *See* APS’ Post-Hearing Brief pp.  
18 4-5.

19       The unprecedented price hikes of last fall, which have to a some extent  
20 ameliorated in early 2006 but are projected to increase even more in 2007, constitute a  
21 “sudden change [that brought] hardship” to APS within the meaning of the 1971  
22 Attorney General’s Opinion. Thus, the assertion in the Recommended Order that “an  
23 ‘emergency’ does not exist” (R.O. at 23) is incorrect as a matter of law. Accordingly,  
24 APS respectfully submits that the Commission should reject the Recommended  
25 Order’s conclusion that no “emergency” exists , and that the Commission’s Order  
26

1 should state that there exists an emergency warranting emergency interim rate relief  
2 with respect to APS' unrecovered fuel and purchased power costs.

3 See APS' Proposed Amendment #1 attached hereto.

4 **II. THE RELIEF PROPOSED IN THE RECOMMENDED ORDER IS**  
5 **INSUFFICIENT AND PRESENTS A SUBSTANTIAL RISK THAT APS'**  
6 **CREDIT RATING WILL BE FURTHER DOWNGRADED TO "JUNK"**  
7 **STATUS, AT HUGE COST TO THE COMPANY, ITS CUSTOMERS**  
8 **AND THE STATE OF ARIZONA GENERALLY.**

9 The fundamental premise of the Recommended Order is that a 5 mill interim  
10 increase in the bandwidth of the existing PSA, or more precisely, implementation of  
11 an interim PSA adjustor of 5 mills in addition to the existing 4 mill PSA adjustor, to  
12 take effect on May 1, 2006, will reduce APS' 2006 unrecovered fuel and purchased  
13 power balance to \$110 million (not including additional 2006 costs related to  
14 "unplanned outages") by the time the new annual 4 mill PSA adjustor takes effect on  
15 February 1, 2007. That premise, however, even if proven accurate, ignores the very  
16 cause of the emergency -- *i.e.*, the inability of APS to recover actual and projected  
17 fuel and purchased power costs on a "timely and full" basis. The proposed 5 mill  
18 bandwidth increase as of May 1, 2006 would, in fact, leave APS with an unrecovered  
19 fuel and purchased power balance at the end of 2006 of at least **\$210 million**. As  
20 such, the proposed interim 5 mill adjustor fails to address adequately the crisis  
21 presented by the imbalance between revenues and the cost of fuel and purchased  
22 power. In fact, that \$210 million shortfall at year-end 2006 under the proposal in the  
23 Recommended Order would exceed by at least \$40 million the cash recovery shortfall  
24 at year-end 2005 that caused the credit downgrading by S&P on December 21, 2005.<sup>2</sup>

24 <sup>2</sup> Note again that the issue with the rating agencies is less the certainty of recovery than the  
25 timing and adequacy of recovery. Thus, they focus on the total amount of under-recovered costs  
26 during a period of time rather than whether or not there have been questions raised over eventual  
recoverability.

1 Briefly stated, APS' unrecovered fuel and purchased power costs for 2006 will  
2 be at least \$248 million as of year-end 2006 if nothing is done. An additional  
3 \$50 million in unrecovered 2005 fuel deferrals related to the step one surcharge (to be  
4 partially collected in 2006 starting May 1) and the step two surcharge (which is not  
5 addressed in the Recommended Order) still remain.<sup>3</sup> Added to those sums is  
6 approximately \$11 million of uncollected 2005 deferrals that will not be collected in  
7 2006 under the 4 mill adjustor implemented February 1, 2006. Against that total of  
8 \$309 million of unrecovered 2005 and 2006 fuel and purchased power costs, the  
9 proposed 5 mill adjustor of the Recommended Order would amortize only \$97 to \$99  
10 million of those costs in 2006, leaving a balance of unrecovered costs at year-end  
11 2006 of approximately \$210 million.<sup>4</sup>

12 Of course, as the Commission will remember, it was the Company's  
13 unrecovered balance of \$170 million as of year-end 2005 that caused S&P to  
14 downgrade APS to the brink of "junk" status on December 21, 2005 -- even though  
15 the Company had pending at that time an \$80 million surcharge application that the  
16 rating agencies knew was unopposed and even though it was believed by S&P that the  
17 Company would receive a 4 mill rate increase effective April 1, 2006. Thus, with the  
18 rating agencies having expressed their concerns about the year-end 2005 balance and

19 <sup>3</sup> This assumes that the \$15 million surcharge recently approved by the Commission becomes  
20 effective May 1, 2006..

21 <sup>4</sup> Specifically, the 2006 Unrecovered Fuel and Purchased Power Costs as of 12/31/06 under the  
Recommended Order would be:

22	Estimated Fuel Cost Deferrals in 2006 Tracking Account	\$248 million
23	Balance in Feb. 2006 Adjustor Account	\$ 11 million
24	Balance in Step 1 Surcharge Account	\$ 4 million
25	Balance in Paragraph 19(d) Account	\$ 46 million
26	Recovery of 2006 Deferrals From May 2006 5 Mill Adjustor	<u>\$(99)</u> million
	Expected 2006 Year-End Deferred Fuel Balance	\$210 million

1 having made it clear that they are looking to this emergency rate proceeding for  
2 regulatory action that allows APS “**timely and full**” recovery of its fuel and  
3 purchased power costs in 2006 (see Part III of APS’ Post-Hearing Brief), a  
4 recommendation for interim rate relief that leaves APS in a worse financial situation  
5 at year-end 2006 than that of year-end 2005 is simply insufficient. If accepted by the  
6 Commission, it would needlessly expose APS and its customers to a substantial risk  
7 of the huge financial consequences of a downgrade to “junk” status. (See APS  
8 Exhibit 6 regarding the relative risk of a further downgrade and the related testimony  
9 of Mr. Brandt and Mr. Fetter confirming the accuracy of those estimates.)

10       The Recommended Order also errs in its analysis of the effect of the proposed  
11 5 mill adjustment on the Company’s FFO/Debt ratio. The Recommended Order, at  
12 n.16, asserts that imposition of a 5 mill expansion in the bandwidth effective May 1,  
13 2006, would raise the FFO/Debt ratio to 17.8 percent. Left unstated by the  
14 Recommended Order, however, is the point at which the ratio would rise to that  
15 number. Significantly, given the rate of amortization provided by the proposed  
16 interim 5 mill adjustor, the Company’s FFO/Debt ratio would rise to 17.8 percent  
17 only at the very end of the year. For most of the intervening eight months, that ratio  
18 would be well below 17.8 percent. And the ratio would not remain at 17.8 percent  
19 into 2007 -- to the contrary, immediately after January 1, 2007, as the Company  
20 begins to incur additional unrecovered fuel and purchased power costs for 2007, the  
21 FFO/Debt ratio under the proposal in the Recommended Order will begin to move  
22 downward again (at least until the conclusion of the general rate case).

23       Moreover, without APS’ \$44.5 million step two surcharge becoming effective  
24 as of July 1, 2006, the actual year-end 2006 FFO/Debt ratio under the interim 5 mill  
25 PSA adjustor proposed in the Recommended Order would be no more than 17.2%  
26 (and would begin to drop immediately after January 1, 2007, as noted above).

1 More importantly, as both Mr. Brandt and Mr. Fetter testified during the  
2 hearing (and as Staff witness Dr. Woolridge agreed), within business profile 6, a  
3 FFO/Debt ratio of 18 percent is the absolute minimum guideline for a company to  
4 remain within investment-grade territory and it is unwise and "very dangerous" to  
5 target a mere 18 percent FFO/Debt ratio. (See Part I(D) of APS' Post-Hearing Brief)

6 As Mr. Fetter testified:

7 [T]hese are very dangerous times for a utility to be near the threshold  
8 between investment-grade and non-investment-grade ratings. For a  
9 utility with such weak ratings, one negative blip of any type -- whether  
10 it be nuclear performance, severe weather, new legislative or regulatory  
11 mandates that raise costs and questions of ultimate recovery (such as the  
12 power supply situation here) or other operational challenges -- can push  
13 that company into junk status, at an immediate cost to investors and an  
14 eventual financial impact on customer rates.

15 (APS Post-Hearing Brief at 16, quoting Fetter Rebuttal Testimony, APS Exhibit 7, at  
16 19.)

17 Notwithstanding this undisputed evidence in the record of the risk of targeting  
18 an 18 percent FFO/Debt ratio for APS under present circumstances, the 5 mill  
19 adjustor proposed by the Recommended Order will (1) fail to cause the FFO/Debt  
20 ratio to rise to that level; (2) will at best cause the Company's FFO/debt ratio barely to  
21 approach **18 percent only for a brief period**, and then not until the end of 2006; and  
22 (3) will do nothing to prevent the ratio from immediately starting to decline again as  
23 the Company incurs unrecovered fuel and purchased power costs during 2007.

24 In short, the remedy proposed in the Recommended Order falls short of what  
25 APS will need to avoid another downgrade by the credit rating agencies. Indeed, the  
26 rating agencies will quickly observe that the 5 mill interim adjustor will not permit the  
Company's FFO/Debt ratio to rise to investment-grade levels and that it will result in  
a deferred balance of unrecovered fuel and purchased costs that will **exceed by at least**  
**\$40 million** the balance that existed at the time of the December 2005 S&P

1 downgrade. If the Commission approves the 5 mill interim adjustor proposed in the  
2 Recommended Order, these quantitative factors will create a clear risk of a further  
3 downgrade.

4 Beyond the quantitative factors, however, are the qualitative factors that  
5 factored heavily in the credit rating agencies' downgrading decisions in December  
6 (by S&P) and January (by Fitch) and the decision (by Moody's) in January to place  
7 APS "under review for downgrade" -- specifically, their stated concern about a  
8 perceived lack of regulatory support afforded to APS. Interim relief of no more than  
9 that proposed in the Recommended Order will do little to quell those stated concerns  
10 on the part of the agencies. Indeed, while APS understands the comments in the  
11 Recommended Order about minimizing rate increases for customers, the parties must  
12 remember that the fuel and purchased power costs that give rise to this emergency  
13 proceeding are not discretionary costs; APS must incur these costs (for which APS  
14 receives no profit) to provide electric service to customers, and customers are  
15 responsible for paying these costs. Acknowledgement of that fact by the Commission  
16 constitutes an inherent element of the regulatory support to which the rating agencies  
17 refer.

18 It cannot be denied that the rating agencies are watching this emergency rate  
19 proceeding with great interest and that, unless the Commission provides the Company  
20 with "timely and full" relief from the deferred fuel cost balances, its decision may  
21 cause the agencies to take negative action with respect to APS. In its report dated  
22 January 26, 2006, S&P wrote: "The ACC's vote to limit flexibility of the timing of  
23 the surcharge [in January] **elevates the importance of APS' request for \$299**  
24 **million in interim emergency rate relief, which is expected to be ruled on in**  
25 **April."** Attachment DEB-8 to Brandt Rebuttal Testimony, APS Exhibit 3, at p 1  
26 (emphasis added). In addition, S&P stated in that report that its "stable" outlook for

1 APS was premised on “the ACC providing sustained regulatory support that  
2 adequately addresses building deferrals. **Negative rating actions could result if**  
3 **regulatory support does not continue . . . .**” *Id.* at p. 2 (emphasis added). Two  
4 weeks later -- on February 15, 2006 -- S&P issued another report in which it  
5 commented on the importance of APS’ pending request for “interim rate relief of  
6 \$299 million . . . to avoid significant additional deferrals.” Attachment DEB-17 to  
7 Brandt Rebuttal Testimony, APS Exhibit 3, at p. 2. In that report, S&P went on to  
8 reiterate what it had said in its January 26 report: “**Negative rating actions could**  
9 **result if timely regulatory support is not sustained . . . .**” *Id.* at p. 3 (emphasis  
10 added).

11 Likewise, when Fitch downgraded APS from BBB+ to BBB (and downgraded  
12 Pinnacle West to BBB-) on January 30, 2006, it stated: “The **only** option to recover  
13 fuel and purchased power costs above amounts determined annually in the PSA would  
14 be **an emergency rate filing**, in which the timing and amount of recovery would be  
15 uncertain.” Attachment DEB-10 to Brandt Rebuttal Testimony, APS Exhibit 3, at p.  
16 1-2 (emphasis added).

17 And Moody’s echoed those comments of S&P and Fitch with an equally clear  
18 pronouncement about the importance of the outcome of this proceeding and the need  
19 for “timely and full recovery” of fuel and purchased power costs:

20 An assessment of likely regulatory outcomes will be a significant factor  
21 in concluding the review for downgrade. The ratings of APS and  
22 Pinnacle West are likely to be downgraded unless there are clear signals  
23 that APS will receive **timely and full recovery** of its increased costs  
such that we would expect their credit metrics to return to levels  
commensurate with those of similarly rated utility companies Exhibit 9  
to Brandt Rebuttal testimony, at 2 (emphasis added).

24 As Mr. Fetter testified, the fact that S&P acted in December 2005 to  
25 downgrade APS to BBB- without waiting for the Commission’s decision on the  
26 pending \$80 million surcharge application “indicates the high degree of concern the

1 agency holds on this issue.” Fetter Rebuttal Testimony, APS Exhibit 7, at 26. And,  
2 as Mr. Brandt pointed out at the hearing, S&P asked for daily transcripts of the  
3 Commission hearing on this emergency request, an obvious indication of S&P’s  
4 concern and that they will take the outcome of the proceeding into consideration in  
5 deciding whether to make further credit rating moves regarding APS. Brandt hearing  
6 testimony, p. 1831, lines 19-23.

7 As APS stated in its Post-Hearing Brief, an interim increase in the PSA  
8 adjustor, if sufficient to achieve essentially full recovery of 2006 fuel and purchase  
9 and power costs in a timely manner (*i.e.*, in approximately the next twelve months),  
10 would likely alleviate the cash flow emergency that APS faces and produce  
11 meaningful improvement in the Company’s FFO-to-Debt credit metric. The 5 mill  
12 expansion proposed by the Recommended Order simply cannot achieve that.

13 To be sufficient, the current 4 mill PSA would have to increase to  
14 approximately 13 mills effective as of May 1, 2006 (*i.e.*, an additional 9 mills rather  
15 than the additional 5 mills set forth in the Recommended Order). As reflected in APS  
16 Exhibits 18 and 19, each 1 mill increase in the PSA bandwidth (if effective May 1,  
17 2006) produces about \$20 million of recovery in 2006. Thus, at a level of 13 mills  
18 (coupled with APS’ May 1 surcharge for 2005 costs), there would still remain  
19 approximately \$130 million of unrecovered fuel costs at the end of 2006, but that  
20 amounts to far less than the unrecovered year-end totals under the Recommended  
21 Order. Moreover, APS’ proposed 9 mill increase of the PSA bandwidth would  
22 continue to amortize unrecovered amounts into 2007 until an adjustment is made to  
23 the base rate and to the PSA itself in the general rate case -- a continuity of recovery  
24 that the rating agencies have deemed important for creditworthiness.

25 On the other hand, an increase in the bandwidth of the PSA or the imposition  
26 of an interim PSA adjustor (in addition to the existing 4 mill adjustor approved

1 February 1, 2006) of less than 9 mills or an effective date later than May 1, 2006,  
2 would not produce sufficient cost recovery in 2006 and could leave year-end balances  
3 that would eventually exceed the \$170 million year-end balance that existed at the end  
4 of 2005 and that prompted S&P and the other rating agencies to take adverse rating  
5 actions against APS.<sup>5</sup> Indeed, because the rating agencies (particularly S&P) have  
6 repeatedly stated that their pessimistic financial projections for APS (and their credit  
7 downgrades of APS) stem in large part from the insufficiency and uncertainty of  
8 timely recovery under the existing PSA, it would be inconsistent with the purpose of  
9 any expansion of the bandwidth for the Commission to make interim adjustments to  
10 the PSA that the rating agencies view as insufficient to deal with APS' mounting  
11 unrecovered fuel and purchase power costs. There is no benefit to customers from  
12 further delaying or even significantly slowing this necessary recovery of prudently  
13 incurred costs. And because APS seeks only to recover on a timely basis costs which  
14 it has an unquestioned right to recover from customers, an increase of the bandwidth  
15 of the PSA pending the outcome of the general rate case should be designed to  
16 achieve recovery of such costs on a relatively current basis. Anything short of that  
17 goal will carry with it a substantial risk of a further credit downgrade for APS. There  
18 is no reason for the Commission to impose that level of risk on the Company and its  
19 customers.

20 Moreover, there is nothing unfair to customers about APS recovering on a  
21 timely basis its prudently incurred costs of providing electric service to customers.  
22 APS has a right to recover those costs, and APS' customers are required to pay those  
23 costs. On the other hand, it would be unfair to customers (and to APS) to impose on

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24  
25 <sup>5</sup> Specifically, it would take at least an **additional** 7 mills just to reduce the balance of  
26 unrecovered fuel costs to what it was at the end of 2005 (i.e., \$170 million) based on estimates  
presented at hearing.

1 those customers more than a billion dollars of added and otherwise avoidable  
2 financing costs resulting from a downgrade of APS' credit rating to "junk" status. As  
3 Mr. Fetter testified, no one wants "to pay more for something they paid less for last  
4 year" (hearing transcript p. 643, lines 3-14), but APS' estimated costs of fuel and  
5 purchased power for 2006 are undisputed and such costs are presumptively prudent.  
6 Recognizing that these fuel and purchased power costs eventually must be paid by  
7 customers, it would be imprudent for the Commission to take needless risk that  
8 customers will be required to pay not only these fuel and purchase power costs but  
9 also an added \$1 billion of financing costs resulting from a credit downgrade.

10 Under the circumstances, APS' proposal of an interim PSA increase of at least  
11 9 mills effective May 1, 2006, is both prudent and fair to customers. It significantly  
12 reduces the risk of a further credit downgrade while at the same time giving customers  
13 the assurance that the Commission will have ample opportunity in the general rate  
14 case to examine these costs and make any appropriate adjustments. Indeed, APS'  
15 customers are already paying millions of dollars less than the actual cost to serve  
16 them, and they will continue to do so until the conclusion of the general rate case  
17 because even the APS proposal does not fully recover the projected 2006 fuel and  
18 purchased power costs before that time. Indeed, by failing to increase the base fuel  
19 rate on an interim basis, APS will never recover 10% of its higher and prudently-  
20 incurred fuel costs until final resolution of that permanent rate proceeding.

21 Given the huge potential financing costs that would be passed on to customers  
22 if APS is downgraded to "junk" status and the other adverse financial consequences  
23 of such a downgrade to APS and the people of Arizona generally, the inadequate and  
24 temporary level of interim rate relief proposed in the Recommended Order is contrary  
25 to the interests of APS and its customers and should be rejected by the Commission.

26 See APS' Proposed Amendment #2 attached hereto.

1 **III. THE FORMULAIC APPROACH TO CALCULATING THE INTERIM**  
2 **ADJUSTOR PROPOSED IN THE RECOMMENDED ORDER IS**  
3 **IMPRECISE AND SHOULD BE REJECTED**

4 The discussion in the Recommended Order at page 24 and in footnote 12  
5 indicates that the proposed 5 mill interim PSA adjustor is a calculated rate using the  
6 “formula” set forth in footnote 12. Under this formula, the proposed 5 mill interim  
7 adjustor is actually less than 5 mills. The interim adjustor will only equal 5 mills, and  
8 the February 2007 adjustor will be sufficient to recover the remainder of 2006 fuel  
9 costs by early 2008, if the numbers in footnote 12 are accurate and are consistent with  
10 the description of what the numbers were intended to represent in the text of the  
11 Recommended Order.<sup>6</sup>

12 Moreover, the 2006 “tracking account” (even aside from unplanned outage  
13 costs) will only be reduced to \$110 million if there are no other increases in fuel costs  
14 between now and the end of 2006. Given that gas prices have already begun to rise  
15 and that the biggest increase in gas/power prices during 2005 happened in the second  
16 half of the year, this is a very optimistic assumption.

17 There is additional ambiguity in the Recommended Order’s formulaic  
18 approach as to how long the interim adjustor would remain in place. What happens if  
19 the 2006 “tracking account” (excluding unplanned outages, however defined) is  
20 reduced to \$110 million before the end of 2006? What if that account is still over  
21 \$110 million by the end of 2006? Since the 2006 “tracking account” balance as of  
22 year end 2006 will be converted to the 2007 “adjustor account” and, to the extent

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21 <sup>6</sup> Specifically, the amount (\$41 million) cited in the Recommended Order for 2006  
22 “unplanned outage” costs, which are apparently to be excluded from the proposed interim adjustor, is  
23 an after-tax number used in the Company’s financial disclosures that had a significant allowance for  
24 contingencies for the sake of conservatism. It also reflects an allowance for unplanned outage costs  
25 already in the Company’s 2006 budget and is net of power plant performance that is above budgeted  
26 levels. To APS, this reflects “the amount [of costs] associated with **any** unplanned outages.” (R.O. at  
24, emphasis added.) However, it is not clear from the Recommended Order that such a calculation  
of unplanned outage costs is either adopted or rejected. Assuming the Recommended Order intends  
to adopt the Company’s methodology of determining increased costs attributable to unplanned  
outages, the correct number would be \$44 million and not \$41 million, thus making the adjustment  
slightly less than 5 mills and the resulting FFO/Debt metric slightly less than the anticipated 17.8%.

1 outside the 4 mill bandwidth, the "Paragraph 19 (d) account, it would appear that the  
2 interim adjustor would stop even though it had not accomplished either of its intended  
3 goals of reducing the "tracking account" to \$110 million or increasing FFO/Debt to  
4 17.8%.

5 In addition to creating a whole new level of uncertainty about the level and  
6 timing of fuel cost recovery, the idea of targeting a given level of unrecovered fuel  
7 costs as somehow acceptable is fundamentally flawed.<sup>7</sup> It depends on too many  
8 variables and it fails to recognize that "timely and full" recovery of fuel costs should  
9 be the goal. Thus, the Commission should simply set the interim adjustor at the level  
10 it finds appropriate and leave it in effect until it decides the Company's permanent  
11 rate case.

12 See APS' Proposed Amendment #2 attached hereto.

13 **IV. THE FUEL AND PURCHASED POWER COST SHORTFALLS SO**  
14 **DOMINATE APS' FFO/DEBT RATIO THAT IT IS UNREASONABLE**  
15 **AND IMPRACTICAL TO EXPECT THAT FURTHER COST-**  
16 **CUTTING BY APS WILL RETURN ITS BUSINESS PROFILE TO 5**  
17 **AND MAINTAIN ITS RATIO ABOVE 18 PERCENT.**

18 The Company fully acknowledges its obligation to responsibly and prudently  
19 manage its business. But APS must take exception to the statements in the  
20 Recommended Order that APS can bring its FFO/Debt ratio to above 18 percent, can  
21 cause APS to receive a business profile of 5, and should "insure" that those credit  
22 metrics stay at that level by implementing further cost-cutting measures. *See, e.g.,*  
23 *R.O., pp. 28 and 36.* APS has already implemented extensive cost-cutting measures,  
24 and has done so for many years.

25 First, the Company has had a long established focus on cost management  
26 which involves all levels of the organization and has produced dramatic results. The

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<sup>7</sup> Also flawed is the Recommended Order's apparent belief that unplanned outage costs should only be recovered through the PSA surcharge mechanism. These costs are as presumptively prudent as other APS fuel costs and are subject to the same after-the-fact prudence reviews as such other costs, and thus do not warrant any special treatment under the PSA mechanism.

1 Company's total non-fuel unit costs have decreased almost a full penny per kWh from  
2 1995 to 2005, or about a 12% reduction. This reduction was accomplished (despite  
3 significant increases in the cost of raw materials and other items) due to the  
4 Company's disciplined cost management approach utilizing our incentive process to  
5 reward and reinforce desired employee behavior. Additionally, given the significant  
6 increase in fuel expenses, particularly natural gas, the Company performed a detailed  
7 department-by-department analysis in developing the 2006 budget. Despite significant  
8 increases in the cost of gasoline, cement, copper wire, steel and many other items,  
9 APS kept non-fuel O&M costs flat on a per-kWh basis. Subsequently, APS has  
10 implemented yet additional cost controls in the areas of payroll, travel and other  
11 items.

12 Second, the revenue imbalance caused by uncollected fuel and purchased  
13 power costs dwarfs the operational and other expenses referenced in the  
14 Recommended Order. In addition, the sums paid to its employees for superior  
15 performance over the past few years through the Company's incentive bonus plan  
16 have had remarkably successful results. Since the introduction of its incentive  
17 program, APS serves 300,000 more customers with a 7 percent smaller workforce.

18 Third, all non-fuel O&M expenses were again re-evaluated in early 2006.  
19 Through this process, all such expenses were categorized into three areas: (1)  
20 expenses that could not be further cut without directly affecting service to customers;  
21 (2) expenses that if further cut would result in higher costs in the long run; and (3)  
22 expenses already committed to (contractually, by Commission order, by statute, etc.).  
23 The vast majority, more than 90%, of the Company's non-fuel O&M costs relate to  
24 the first two items with the remainder being commitments previously made.  
25 Obviously, these commitments could not be eliminated even if that were desirable.  
26 These commitments included items affecting customers such as demand-side

1 management, rents/leases, and ACC/FERC regulatory fees. They also included most  
2 of advertising costs and organization dues/fees.

3 Fourth, neither APS nor PWCC can “insure” that APS will always have  
4 investment-grade credit metrics. There are simply too many factors over which these  
5 entities have no control (some of which, as Mr. Fetter pointed out, include weather,  
6 legislative mandates, geopolitical events, and other factors). *See* Fetter Rebuttal  
7 Testimony, APS Exhibit 7, at 19. Moreover, APS cannot simply reduce its costs by  
8 refusing to provide service. Neither can it raise its prices to cover higher costs without  
9 regulatory approval. As to regaining its “Business Position 5,” as is suggested by the  
10 Recommended Order, the business position for APS is almost entirely a matter of  
11 S&P’s perception of the Company’s regulatory climate.

12 On this last point, it is important to remember that, over the last eleven months,  
13 PWCC has already infused \$460 million in additional equity into APS for which it has  
14 yet to receive any compensation. PWCC did this in order to strengthen APS’ financial  
15 condition and preserve its liquidity. This action was required to offset the growing  
16 disparity between costs and prices for fuel as well as the need to strengthen the APS  
17 capital structure. Without this equity infusion, which had a more dramatic positive  
18 impact on APS’ FFO/Debt ratio than would the Recommended Order’s level of rate  
19 relief, the rating agencies’ actions to date would have been even more severe, and the  
20 amount of rate relief needed in this proceeding to reach even a minimum 18%  
21 FFO/Debt ratio would be considerably **higher** (by some \$100 million).

22 Moreover, any cost-cutting conditions placed on interim relief in this  
23 proceeding would fly in the face of the very reason that we commenced this  
24 emergency proceeding -- the under collection of prudently incurred fuel and  
25 purchased power costs that APS has an indisputable right to recover from customers.  
26 To suggest that APS, in order to recover these fuel costs, must cut other costs (which

1 APS deems reasonable and appropriate in the exercise of its management judgment) --  
2 most of which it pays for from shareholder earnings -- would run contrary to law as  
3 interfering with proper management prerogative. Indeed, rating agencies and investors  
4 would also fear further uncertainty about the Commission's intent to permit APS to  
5 recover prudently incurred fuel and purchased power costs.

6 In truth, APS' other costs -- unrelated to fuel and purchased power -- have not  
7 caused the current emergency situation that faces the Company. In the general rate  
8 case, the Commission will have ample opportunity to scrutinize APS' costs to  
9 determine which costs, sought to be included in rates, are prudently incurred. This  
10 emergency interim rate proceeding, which seeks to address unrecovered fuel and  
11 purchased power costs, is not the appropriate place to address operational cost issues.  
12 The legal issues relating to the propriety of mandates by the Commission concerning  
13 discretionary expenditures by Company (such as employee incentives, community  
14 support, etc.) have not been adequately raised or briefed in this proceeding, and  
15 therefore they should not be a part of the Commission's Order in this proceeding.  
16 While the Commission may view these minor costs as a source of leverage over APS,  
17 they, too, form an integral element of successfully running a company, retaining  
18 quality employees, and supporting Arizona and the communities APS serves.

19 Thus, APS respectfully submits that statements in the Recommended Order  
20 that "APS [is] to manage its operations in such a manner (including its generation  
21 assets) . . . [so that] its business profile returns to 5, its FFO/Debt ratio continues to  
22 improve, and its credit rating remains investment grade" (R.O. at 28) and that  
23 "Arizona Public Service Company and Pinnacle West Capital Corporation shall take  
24 appropriate steps to **insure** that Arizona Public Service Company's financial ratios  
25 remain investment grade" (R.O. at 36, emphasis added) are unwarranted,  
26

1 inappropriate, and essentially unattainable conditions to the grant of interim rate relief  
2 that should be rejected by the Commission.

3 See APS' Proposed Amendment #3 attached hereto.

4 **VI. CONCLUSION**

5 For these reasons, the Recommended Order should be modified by the  
6 Commission in accordance with the proposed amendments attached hereto.

7  
8 RESPECTFULLY SUBMITTED this 24<sup>th</sup> day of April, 2006.

9  
10 PINNACLE WEST CAPITAL CORPORATION  
11 Law Department

12   
13 Thomas L. Mumaw

14 OSBORN MALEDON, P.A.

15 \_\_\_\_\_  
16 William J. Maledon  
17 Diane M. Johnsen

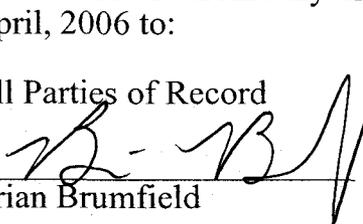
18 Attorneys for Arizona Public Service Company

19 Original and 13 copies of the foregoing  
20 filed this 24<sup>th</sup> day of April, 2006, with:

21 Docket Control  
22 Arizona Corporation Commission  
23 1200 West Washington  
24 Phoenix, AZ 85007

25 And copies of the foregoing mailed, faxed or  
26 transmitted electronically this 24<sup>th</sup> day of  
April, 2006 to:

All Parties of Record

  
Brian Brumfield

**THIS AMENDMENT:**

\_\_\_\_\_ Passed \_\_\_\_\_ Passed as amended by \_\_\_\_\_

\_\_\_\_\_ Failed \_\_\_\_\_ Not Offered \_\_\_\_\_ Withdrawn

**APS PROPOSED AMENDMENT # 1**

Time/Date Prepared: April 24, 2006

Company: Arizona Public Service Company

Agenda Item No.

Docket No.: E-01345A-06-0009

Open Meeting Date: May 2, 2006

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Page 22, Line 17, DELETE: "Although"

Page 22, Lines 17 – 22, DELETE: "deflecting responsibility ... performs"

Page 23, Lines 16 – 27, DELETE: "Although not specified... purchased power costs."

Page 23, Line 16, INSERT:

"The threat of a further credit rating downgrade to a non-investment grade status and the resultant imposition of restrictive credit terms and conditions that would ultimately be borne by APS customers, combined with the extremely large and growing fuel costs that have been unrecovered and the continuing escalation of fuel and purchase power costs constitutes circumstances where the Commission may grant emergency rate relief. However, we believe that the appropriate remedy to address the emergency is to grant APS an interim adjustor, rather than a change in base rates."

Page 27, Line 18, INSERT: "base" between "interim" and "rate".

Page 31, Lines 15-23, DELETE: Findings of Fact Nos. 24 through 26.

Page 31, Lines 15-17, INSERT: New Finding of Fact No. 24.

The threat of a further credit rating downgrade to a non-investment grade status and the resultant imposition of restrictive credit terms and conditions that would ultimately be borne by APS customers, combined with the extremely large and growing fuel costs that

have been unrecovered and the continuing escalation of fuel and purchase power costs constitutes circumstances where the Commission may grant emergency rate relief.”

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Page 34, Line 21, DELETE: “necessary”.

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Page 35, Line 13: DELETE: “No” and REPLACE with “An”.

Line 13, INSERT: “an” between “of” and “emergency”.

Line 13, DELETE: “rates” and REPLACE with: “PSA adjustor”.

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Page 36, Line 1, DELETE: “denied” and REPLACE with “granted to the extent set forth herein”.

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1824816.1

**THIS AMENDMENT:**

\_\_\_\_\_ Passed \_\_\_\_\_ Passed as amended by \_\_\_\_\_

\_\_\_\_\_ Failed \_\_\_\_\_ Not Offered \_\_\_\_\_ Withdrawn

**APS PROPOSED AMENDMENT # 2**

Time/Date Prepared: April 24, 2006

Company: Arizona Public Service Company

Agenda Item No.

Docket No.: E-01345A-06-0009

Open Meeting Date: May 2, 2006

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Page 24, Lines 18 – 21, DELETE: “We believe...unplanned outages”, including footnote no. 11.

Page 24, Line 18, INSERT:

“APS should implement an additional interim adjustor of 9 mills per kWh. This interim adjustor shall remain in effective until the resolution of APS’ general rate case (Docket No. E-01345A-05-0816).”

Page 24, Line 22, DELETE: “5” and REPLACE with: “9”.

Page 24, Line 24, DELETE: “\$4.09” and REPLACE with: “\$7.36”.

Page 24, Line 24, DELETE: “\$5.23” and REPLACE with: “9.42”.

Page 24, Lines 26-28, DELETE: Footnote no. 12 in its entirety.

\_\_\_\_\_

Page 25, Line 1, DELETE: “\$2.66” and REPLACE with: “\$4.78”.

Page 25, Line 2, DELETE: “\$3.38” and REPLACE with: “6.09”.

\_\_\_\_\_

Page 31, Lines 6-8, DELETE: Finding of Fact No. 21 in its entirety.

\_\_\_\_\_

Page 33, Line 4, DELETE: "\$4.09", and REPLACE with: "\$7.36".  
Line 4, DELETE: "\$5.23", and REPLACE with: "\$9.42".  
Line 5, DELETE: "\$2.66", and REPLACE with: "\$4.78".  
Line 6, DELETE: "\$3.38", and REPLACE with: "\$6.09".

Page 33, Line 11, DELETE: "approximately four"  
Line 11, INSERT: "s" on the word "million" and "of" after the same word.

Page 33, Line 15, DELETE: "and that no .... the interim adjustor".

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1824820.1

**THIS AMENDMENT:**

\_\_\_\_\_ Passed \_\_\_\_\_ Passed as amended by \_\_\_\_\_  
\_\_\_\_\_ Failed \_\_\_\_\_ Not Offered \_\_\_\_\_ Withdrawn

**APS PROPOSED AMENDMENT # 3**

Time/Date Prepared: April 24, 2006

Company: Arizona Public Service Company

Agenda Item No.

Docket No.: E-01345A-06-0009

Open Meeting Date: May 2, 2006

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Page 28, Lines 17- 21, DELETE: "In light of ...its FFO/Debt ratio".

Line 21 DELETE: "while"

Line 23, INSERT: a period (.) after "proceeding"

Lines 23-26, DELETE: "we expect...investment grade" and REPLACE with:  
"We do expect APS to manage its operation (including its generation assets) in a prudent manner."

Page 34, Lines 22-24, DELETE: Finding of Fact No. 59 in its entirety.

Page 34, Lines 25 -28, DELETE, Finding of Fact No. 60 and REPLACE with:

"We are not imposing restrictions on APS dividend payouts or dictating that certain expenses be eliminated in this proceeding. We do expect APS to manage its operations (including its generation assets) in a prudent manner."