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0000057608

A subsidiary of Pinnacle West Capital Corporation

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Brian Brumfield
Supervisor
Regulatory Affairs

Tel. 602-250-2708
Fax 602-250-3003
e-mail Brian.Brumfield@aps.com

Mail Station 9708
PO Box 53999
Phoenix, Arizona 85072-3999

August 4, 2006

Commissioner Jeff Hatch-Miller
Commissioner William Mundell
Commissioner Mike Gleason
Commissioner Kristin K. Mayes
Commissioner Barry Wong
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007-2996

Arizona Corporation Commission
DOCKETED
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RE: APS Rate Case Docket No. E-01345A-05-0816

Dear Commissioner Jeff Hatch-Miller:

On July 26, 2006 the Company filed in Docket a copy of a Moody's Investor Services report in response to a request by Chairman Hatch-Miller. However, the report filed was in fact not the requested report. Attached is the Standard & Poor's research article titled "U.S. Public Power Utilities' Self-Governance Bolsters Credit Quality" as originally requested by Chairman Hatch-Miller in his letter dated July 21, 2006. I apologize for any confusion this may have caused.

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

Sincerely,

Brian Brumfield
Supervisor
Regulatory Affairs

BB/bec

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RESEARCH

U.S. Public Power Utilities' Self-Governance Bolsters Credit Quality

Publication date: 19-Jul-2006
Primary Credit Analyst: David Bodek, New York (1) 212-438-7969;
mailto:david_bodek@standardandpoors.com

(**Editor's Note:** This article was adapted from a speech given at JPMorgan's 2006 Public Power and Gas Conference on May 11, 2006.)

Standard & Poor's Ratings Services has a favorable view of the U.S. public power sector. This is evident from a ratings distribution for public power utilities that very closely mirrors credit quality in the water and sewer sectors, even though public power utilities face greater operational and market challenges. In the public power and water and sewer utility sectors, 85% of the ratings are in the 'A' category or higher. Given the complex issues facing the power sector as compared with those facing water and sewer utilities, the similarities in the ratings distributions is really quite extraordinary.

Chart 1

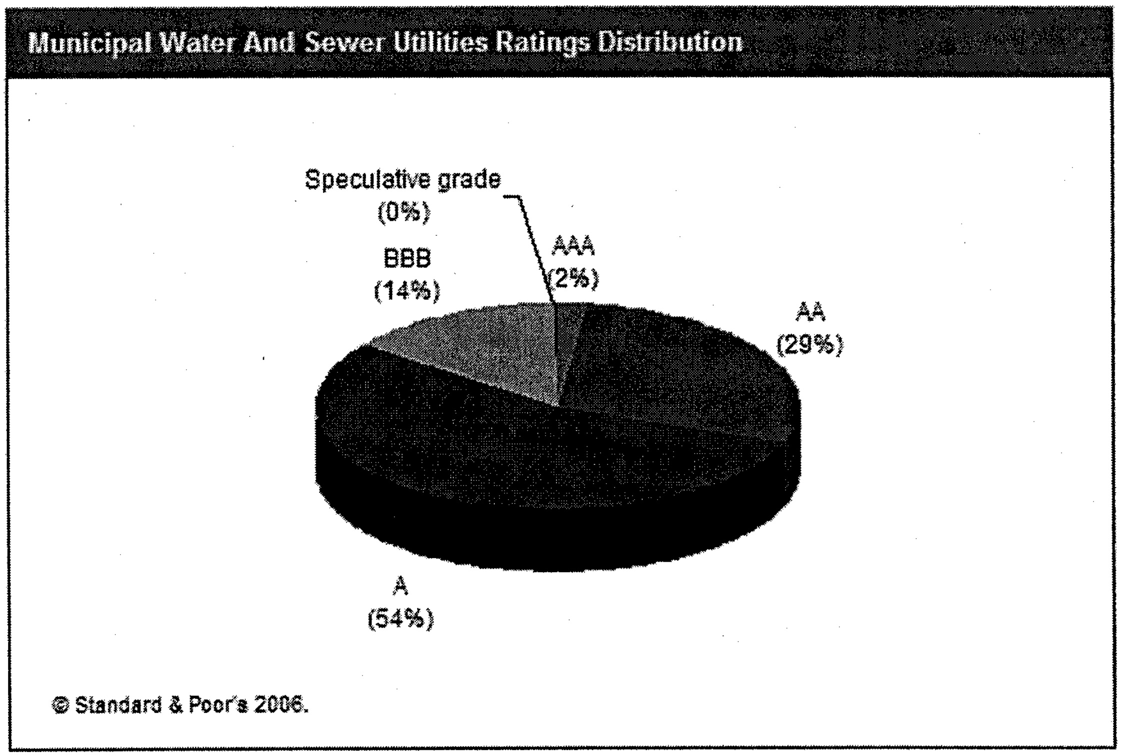
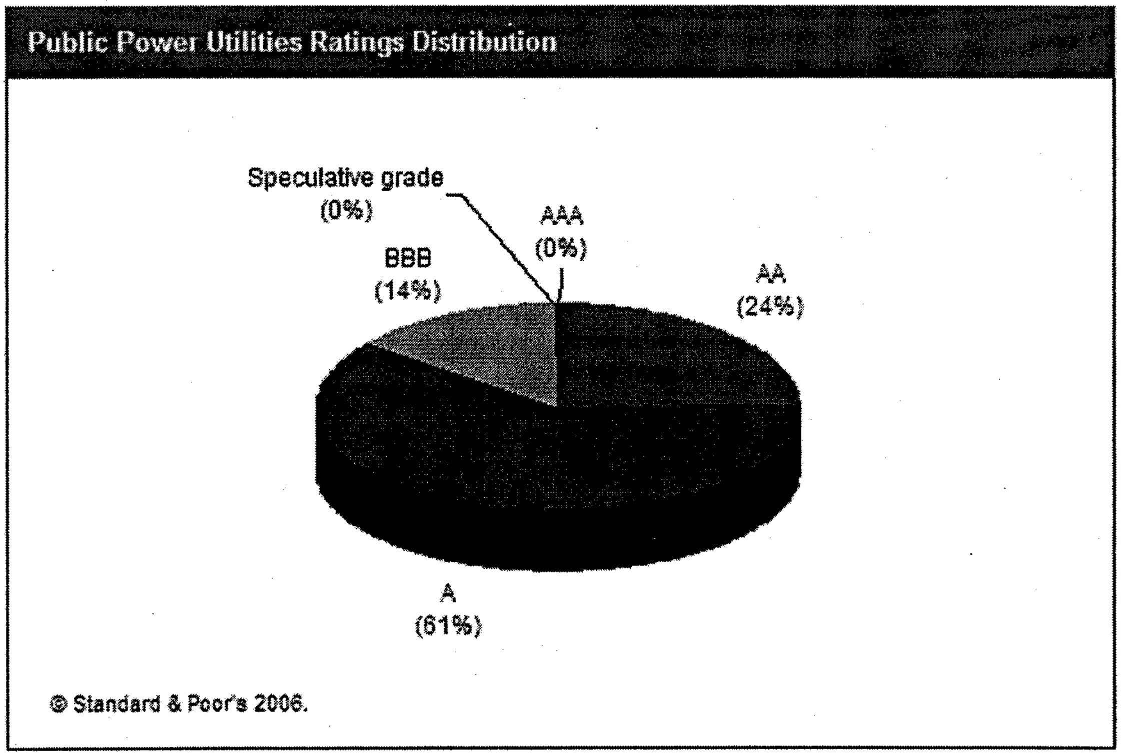


Chart 2



The similar ratings on utilities in these two sectors are based on several attributes that distinguish public power and other municipal utilities from investor-owned utilities. Like water and sewer utilities, the credit quality of public power utilities tends in the first instance to be defined by the interplay between autonomous rate setting authority and service area demographics. Autonomous rate setting is an important driver of credit quality because it provides public power utilities with the tools needed to respond quickly to changes in operating costs or capital needs. There are instances where public power utilities have chosen not to take advantage of these tools, which has had rating implications, but these tend to be limited cases. Examples in recent years included the electric utilities serving Lodi, Calif. and Jacksonville, Fla.

This rate setting authority continues to be one of the key factors that distinguishes the ratings on public power utilities from those on investor-owned electric utilities. The credit quality of investor-owned utilities generally suffers as a result of the regulatory lag and the potential for regulatory disallowances of costs.

Last year, the advantages of autonomous rate setting authority and the benefits of pass through mechanisms were in evidence as public power utilities successfully weathered dramatic increases in natural gas prices, preserving their financial margins and credit ratings. In fact, Illinois Municipal Energy Agency preserved a strong alignment of revenues and expenses during this period and was upgraded to reflect this and other positive developments.

In the rate adjustment arena, public power has also shown that slow and steady wins the race. Public utilities tend to implement palatable incremental rate adjustments to preserve financial performance and flexibility. Just compare investor-owned utilities in states like Illinois and Maryland where long-term rate freezes will soon expire and customers and legislators are fretting over prospects of steep rate increases.

That is not to say that public power is immune from these problems. Los Angeles' Department of Water and Power provides a case in point. There, rates were frozen about 10 years ago. The utility is now finding that it must jump through many hoops before it can implement a power cost adjustment mechanism and has needed to retain a third-party consultant to demonstrate to city council and community groups that rate adjustments are needed in response to higher costs.

Another important factor supporting strong credit quality among public power utilities is their narrow strategic focus and limited business scope compared with investor-owned utilities. By and large, public power utilities have not digressed from a business model under which management teams dedicate their efforts to providing reliable, reasonably priced electric service--no more, no less. This has meant that public power utilities have not placed capital at risk in the pursuit of elusive profits as many investor-owned utilities have done. In fact, the pursuit of earnings growth has proved to be the Achilles heel for the financial performance and credit quality of many companies in the investor-owned sector in recent years.

Much of what has been cited so far in support of public power's strengths can be said for water and sewer utilities. Yet, public power is different. Public power ratings are not solely premised on rate setting, a conservative business model, and demographics. Our public power ratings also incorporate operational issues that eclipse those facing water and sewer utilities.

Public power utilities face significant risks, including:

- Fuel price volatility,
- Wholesale electricity commodity price volatility,
- Fuel supply issues, including transportation issues that are plaguing many coal-dependent utilities,
- Transmission issues, and
- The need for management to understand and deploy complicated risk management tools.

These are only a few of the myriad issues facing public power. Even so, the addition of these elements of risk to our analysis has nevertheless yielded a strong collective credit profile for the public power sector.

As a result of the differences in the qualitative challenges facing the two sectors, there are fewer public power utilities rated 'AA' compared with water and sewer utilities, but the approximately five percentage point difference is small.

It is our view that public power has the potential to preserve its strong credit quality as is evidenced by the stable outlooks associated with 92% of our public power ratings. Just the same, ongoing rating stability is not something that will happen of its own accord. Public power utilities will continue to need to actively demonstrate the presence of the technical and political wherewithal to deal with significant challenges that lie ahead.

The principal challenges that we see on the horizon are tied to:

- Resource needs,
- Fuel supply,
- Environmental compliance including renewable portfolio standards and, as history has shown,
- Unforeseen challenges.

Resource needs are of particular significance to the power industry at this time. It has been many years since public power utilities have, as a group, embarked on significant baseload-generation additions. Now, numerous public power utilities across the country are responding to the need for additional baseload capacity to serve customers.

California's Sacramento Municipal Utility District recently added a 500 MW combined cycle gas turbine to its fleet. South Carolina's Santee Cooper is in the process of adding two 580 MW coal-fired baseload units. Santee Cooper's board also approved a third coal unit. Beyond Santee Cooper, the Southeast is replete with evidence of baseload capacity additions. For example, the several utilities serving various Florida cities such as Gainesville, Jacksonville, Tallahassee, and others are all at various stages in their pursuit of baseload coal capacity additions. The American Heartland is also very much a part of this pursuit as is evidenced by public power investments in Prairie State Energy Campus, Council Bluffs Energy Center, Iatan Unit 2, and Nebraska City Unit 2.

As sizable projects proceed, the preservation of credit quality will hinge on a demonstration that those pursuing these projects can appropriately manage all of the associated risks, including:

- Construction risk;
- Uncertainty of future energy markets, including the ability to manage any surplus capacity that might result from capacity additions;
- Fuel risk, including price risk as well as sufficiency of supply and transportation; and
- Co-owner risk that may arise from partnering with companies in the independent power producer sector or even with co-owners of varying credit quality within the public power community as part of a joint powers authority.

It is our view that, with few exceptions, the public power community has repeatedly risen to the challenges presented by a very dynamic energy marketplace. The preponderance of stable outlooks reflects our expectations that public power utilities will continue to respond to the cited risks and changes in circumstances in a manner consistent with the preservation of credit quality. We expect the public power community to continue to use their financial flexibility and self governance as tools for preserving financial metrics. Consequently, we continue to have a very robust view of the public power sector's credit quality.