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Arizona Corporation Commission
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Jeff Hatch-Miller, Chairman
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ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007-2996

Re: Regulatory Update on Issues Affecting APS and Its Customers; Docket No. E-01345A-06-0009

Dear Commissioners:

Recent letters by the Commission request information on items addressed in Decision No. 68685. I have not requested any Commissioner meetings to discuss regulatory issues since we filed our emergency request in January 2006 due to *ex parte* restrictions. Although we have responded to discovery requests, they were apparently not sufficient to answer all the Commission's questions, and this letter is provided to more fully respond to the major issues raised in Decision No. 68685 and supplements the information provided in our request for reconsideration, which the Commission denied.

Many of the issues discussed below were direct concerns expressed in that Decision or during deliberation on it and have continued relevance to the Company's pending general rate case. Others are of longer term significance to our provision of reliable electric service to more than 1 million APS customers.

PALO VERDE:

As we have previously reported to the Commission, PV-I has returned to service at full power. Both APS and the Nuclear Regulatory Commission are satisfied that the vibration problems, which have impacted plant performance since the end of 2005, were resolved by the Company's modifications to PV-I. APS is presently forecasting a capacity factor of well over 90% for PV-I during the balance of 2006 and normal operations for 2007 and beyond.

In 2006, Palo Verde Units 2 and 3 have continued to perform as some of the top nuclear units in the world. And Palo Verde as a whole should continue in 2006 to be the top producer of electric power of any nuclear facility in North America – the 14th consecutive year it has held that distinction.

APS COST-CUTTING EFFORTS:

In its Application for Rehearing of Decision No. 68685, APS took exception to what it believed could be construed as attempts by the Commission to inappropriately involve itself in matters of internal Company management. However, our defense of APS management's right and obligation to manage the ongoing operations of the Company was construed by some as opposition or resistance to efficient cost management – quite the opposite is true. Our decision not to appeal the order reflects our desire to demonstrate to you our cost management efforts and our hope that you will both recognize those efforts and support them, while also respecting the need to maintain APS management control over cost decisions and other operational matters.

As explained during the Open Meeting leading to Decision No. 68685, cost-management at APS is a well-established and cornerstone business principle based on individual employee responsibility rather than a compilation of ad hoc executive decrees addressing specific programs. Officers and managers are given goals to accomplish and a budget sufficient, with efficient management, to accomplish those goals under then anticipated circumstances. The accountability for both resources and results rests with the individual members, not a staff department or a corporate mandate.

The success of this culture of cost-containment is undeniable. In Steve Wheeler's letter to you dated January 31, 2006, he noted that APS has reduced non-fuel costs by 12% over the last decade, while nearly doubling the number of customers served. Our overall cost per kWh is the lowest of any Arizona investor-owned or cooperative utility in Arizona, indeed of any major investor-owned utility in the entire Southwest.

In the process of its determination of the final 2006 APS budget, some $35 million in proposed 2006 expenditures were eliminated. In total, the 2006 budget, exclusive of fuel and required increases in pension costs, was just 2% greater than 2005 expenditures despite overall inflation in the economy of 3% (and significantly larger increases in key commodities such as steel, copper and concrete) and a 4% increase in APS customers.

APS also instituted a number of other moves in 2006 of which the Commission was previously aware. The Company imposed limitations on new hires requiring either personal approval of the hire by myself or my approval of a departmental staffing plan. APS expects to be approximately 300 FTE positions under budget by year end 2006. Restrictions on out-of-state travel were imposed and overall travel expenses are some 10% under budget through the second quarter of 2006.

Since Decision No. 68685, APS has taken further steps to minimize costs, even those not included in our prices. All sports sponsorships presently under contract with APS will either not

be renewed or are being transferred to Pinnacle West with no allocation of expense to APS. Although these sports sponsorships were not charged to customers in our pending rate filing, their elimination or transfer out of APS will eliminate them entirely from APS financial results.

One suggested cost reduction mentioned in Decision No. 68685 is the elimination of incentive pay. APS neither has ignored that suggestion nor questioned its intent. In fact, we re-evaluated incentive value, benchmarked our program to others and retained an additional outside compensation expert to provide the Commission with an external, unbiased position. They will be providing their testimony in the rebuttal portion of our base rate case. APS continues to believe their elimination would be unwise and counter-productive. The overall anticipated impact of such elimination of incentive pay on the Company's performance and long-term cost objectives would be detrimental to APS and its customers, both currently and in the long run.

APS incentive or "at risk" pay, which is established by the Board after careful consideration of all relevant factors, is an integral part of overall employee compensation, not some sort of additional "perk." Put another way, base pay plus incentive pay produces compensation at the median of the market for our employees. Indeed, incentive pay has varied from zero for all Company employees to a maximum payout during the past ten years, depending upon the degree to which plan objectives were achieved. Eliminating it is essentially an automatic pay cut to below market levels for precisely the sort of experience and knowledge that is critical in efficient operation of the Company. This would make it impossible to attract and retain such personnel. At a time when recruiting and retaining experienced employees and managers in the utility industry is becoming increasingly more difficult and more competitive, eliminating management incentives would send the wrong signal at the wrong time.

It would also remove what has been the driving force behind a ten-year record of accomplishment in the area of cost containment. "At risk" compensation is now an accepted management tool throughout this country to encourage superior performance. APS is convinced eliminating incentive pay would be a classic case of a "false economy," i.e., one that might appear to save money in the short run but would prove far more costly in the long run. Eliminating incentive pay for any employee subgroup, such as management, non-exempt, etc., would be internally destructive and contrary to our fundamental employee culture

RATE STABILIZATION FUND:

Another concept mentioned in the final open meeting which culminated in Decision No. 68685, and concerning which the Company has given considerable thought, is a "rate stabilization fund" that might partially off-set the need for future rate cases. As with the idea of eliminating management "at risk" compensation, APS has not ignored the Commission's discussion of that concept. But it will respectfully continue to urge that the Commission not adopt such an unwise and potentially illegal policy.

Unlike the recent budget discussions at the Legislature regarding "excess" tax collections, APS revenues do not exceed our costs. In fact, the entire basis of our rate request is predicated

on a revenue shortfall, not a surplus. APS has no surplus revenues to fund a rate stabilization plan.

A "rate stabilization fund" asks customers to "pre-pay" expense increases that may occur in the future or takes expense savings, either from the past or currently, that otherwise would be used to reduce prices to our customers and using them to instead offset future revenue requirements. This is similar to the "rainy day" fund established by the Legislature with excess tax revenues that would otherwise have permitted an additional cut in taxes.

APS has no such past or current customer benefits that have either not already been given to customers or which will not be used to offset revenue requirements in the pending APS rate case. And even changes in costs and revenues that have occurred or will occur after our test period can, under appropriate circumstances, be used to adjust those revenue requirements. A rate stabilization fund could only be established by burdening current APS customers for the benefit of future customers. This is not in the best interest of APS customers and is contrary to many of the rate-making principles established and employed by the Commission.

In addition, taking savings of costs not previously or currently reflected in rates or below-the-line costs, and using them in a "rate stabilization fund" to offset future revenue requirements, as possibly was suggested in Decision No. 68685, essentially confiscates shareholder funds for the benefit of customers. Such a use of shareholder funds would be both illegal, as was noted by the Commission's Chief Counsel during the consideration of Decision No. 68685, and non-sustainable. And it would send a highly detrimental message to the investment community at the very time the Company is striving to maintain its financial integrity in the face of exploding growth.

ADVERTISING AND APS CONSERVATION, ENERGY EFFICIENCY, RENEWABLE ENERGY AND SAFETY INITIATIVES:

Our advertising commitments have been directed to conservation, load management, renewables and safety. In total, APS has presented nearly 800 such messages during Suns, Diamondbacks and Mercury ballgames to date. We have also included these messages in the game programs and run them at the game venues themselves. As stated earlier, this advertising was provided to APS' customers free of charge.

In addition, APS launched a separate media campaign to promote conservation and safety-related messages, which campaign also has not received any customer funding. The Company has financed this radio and television effort by redirecting amounts of advertising time already under contract (and not included in our present rate asking) to these themes and provided over 1100 conservation, renewable and safety messages to the public. Another nearly 2000 messages have already been purchased for the balance of 2006 –which is outside the test period in the pending rate case. Similarly, APS has committed some $400,000 in 2006 to print advertising for this important public service. Safety-related print advertising will amount to another $150,000. And it is important to understand that these efforts do not include "free" advertising for these subjects through Company news releases and Company-provided news

stories, nor have I included non-media print messages such as customer news letters, brochures, and bill boards, or our use of these messages at local theaters prior to their feature presentations. We also make presentations on energy efficiency, safety, renewables, and low income programs to community and business groups on a regular basis.

As a result of the Settlement in the Company's last rate case, APS made a commitment, subject to Commission approval of specific programs, to spend $48 million on energy efficiency and conservation during the years 2005-2007. These programs are directly funded by our customers and approved by the Commission. I would like to highlight some of these programs as well as discuss some other initiatives in the areas of demand-response and renewable energy.

APS initiated a compact fluorescent light ("CFL") program in early October of last year. In partnership with local retailers and CFL manufacturers, over 600,000 CFLs have been sold under the program to date. In 2006, five additional retail chains agreed to participate, giving APS coverage for the program throughout its service area. APS expects sales of CFLs in 2006 to approximate one million.

The Non-Residential program for energy efficiency is still in its early stages, but APS has already received requests for project assistance in excess of $1 million. The overwhelming majority of these requests are from existing APS customers, including some school districts.

The last rate settlement also led to the development of new optional TOU rates for our residential customers having shorter on-peak periods as well as extending off-peak rates to holidays. Since its implementation on July 1 of this year, approximately 3000 APS customers have signed up for these new TOU rates.

APS is also in the process of designing a new optional rate for customers using solar energy. Tentatively called the "Total Solar Rate," it would permit customers to receive from 50% to 100% of their electricity from solar facilities owned by or under contract with APS. APS believes this new rate, which would be voluntary, market based and priced to recover the additional costs of solar generation, will not burden non-participating customers and would be attractive to APS customers interested in solar energy but either unwilling or unable to install solar facilities on their property.

The solar resources offered as part of this program would be in addition to any required by the Renewable Energy Standard ("RES"). They would be recovered through rates from participating customers and not through RES funding. Thus, it should not impact the rates of other customers.

FUTURE RESOURCE NEEDS:

APS has been active in securing the resources needed for current and future APS customers. The success of the renewable RFP and the reliability RFP, both approved in Decision No. 67744, is well known to the Commission. Since then, APS has conducted an RFP for additional resources for the Yuma area – resources that will be urgently needed by the summer of

2008 and has recently filed an application with the Commission for approval to move forward and acquire the necessary new generation. APS is also currently seeking additional base load resources through an RFP. The results of that RFP, which seeks new base load resources after 2009, will be known later this year.

APS is projecting the need for an additional 3000 MW of generation during the next 10 years. The cost of these resources, including associated transmission additions, could be as high as $8 billion. APS anticipates a diverse portfolio of fossil fuels, renewables, and demand-side resources will meet these customer needs. But all will require consistent regulatory support if APS is to have the financial strength to raise the capital necessary to acquire these resources.

The Company has been active in and has previously briefed the Commission on a project called TransWest Express. It would develop new transmission from Wyoming to the Southwest, including Phoenix. This project, which is presently undergoing a feasibility review and would be dependent upon a variety of government approvals, could be completed by 2013 in partnership with a number of other entities, would increase grid reliability, further diversify APS' resource portfolio with clean coal and wind, promote renewables, and access to economic power supplies.

APS has extensive plans for new Arizona transmission that will both enhance reliability and allow for more utilization of Arizona-based generation resources. Indeed, in the most recent 10-Year Plan filed with this Commission, APS shows 300 miles of additional APS transmission in Arizona totaling some 2000 MW of scheduling capability. This effort will not come cheap, and excluding TransWest, APS has plans to spend over $1 billion for this Arizona transmission over the next 10 years.

On the distribution side, APS has yet additional and extensive capital needs. APS expects to add as much as $4 billion in new distribution facilities in the next 10 years. As with generation and transmission, this new investment will require timely and adequate rate treatment by the Commission and a financially strong APS.

CAPITAL EXPENDITURES AND BORROWING NEEDS:

As can be gathered from the above discussion, APS' future capital and borrowing needs will be significant. For just the years 2007-2010, APS will have capital expenditures of some $4 billion based on even conservative assumptions about future resource acquisitions. In addition, already outstanding debt must be refinanced. Taken together, APS anticipates the need to borrow as much as $2.5 billion over the same period referenced above.

RATING AGENCY ACTIONS SUBSEQUENT TO DECISION NO. 68685:

Since the issuance of Decision No. 68685, both Standard & Poor's ("S&P") and Moody's Investors Service ("Moody's") have affirmed their prior ratings for APS of BBB- and Baa2, respectively. Pinnacle West Capital Corporation's ("PWCC") ratings were likewise affirmed,

but at the lower levels of BB+ (junk) and Baa3. The current outlook by S&P for both entities is "stable." Moody's retains its negative outlook.[1]

The two issues discussed by both rating agencies as critical to the Company's continued ability to maintain its already minimally-investment grade credit ratings are (1) the return to normal service of Palo Verde Unit I ("PV-I"), which has happened; and (2) a constructive result in the Company's pending permanent rate case. The first of these has already been addressed, while the second is discussed below.

The reason why these rating agencies place so much emphasis on the general rate case is obvious both by their own pronouncements and the testimony already on file in that proceeding. Although as a result of the Commission's actions in Decision No. 68685, credit metrics reach minimally-acceptable levels by the end of 2006, they will fall rapidly in 2007 without additional rate relief. Attachment DEB-4 to Donald Brandt's Direct Testimony in the permanent rate proceeding indicates an FFO/Debt ratio by the end of 2007 that is lower (less than 14%) than that forecast for 2006 prior to Decision No. 68685. And even with virtually full rate relief in the amount requested on January 31, 2006, APS will likely be in the borderline investment grade category by year-end 2008 due to capital expenditures in the amount of nearly $1.7 billion anticipated in 2007-2008. Thus, Decision No. 68685, although a constructive step to preserve the Company's financial integrity, was just that – a first step. Until there is positive action on the pending permanent rate case, there is great reason for continued concern that APS will not be able to maintain the financial strength to meet future customer needs for reliable power at reasonable cost.

One of the apparent outcomes of Decision No. 68685 is that the additional seven mill "interim" PSA adjuster will expire at the end of 2006 or very shortly thereafter. As I discussed in the preceding paragraph, without a resolution of the permanent rate case and with expiration of the "interim" PSA adjustor, the Company's financial ratios begin to decline rapidly thereafter in 2007.

CONCLUSION:

I hope this letter has provided useful information as to the current questions concerning issues expressed in Decision No. 68685. It also shows the critical need for a positive and timely resolution of the pending APS general rate case. And beyond the current rate proceeding, APS will need continued Commission support for its burgeoning capital needs.

I have further tried to provide updated information on other issues such as Palo Verde, energy efficiency and conservation, safety and future reliability needs. As stated earlier, we have not attempted to discuss these issues with the Commission because of *ex parte* restrictions, however, I want you to know that APS is proactively addressing both the current situation facing it and its customers as well as the long term needs of those customers and of this state.

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[1] PWCC had been under "review" by Moody's immediately after Decision No. 68685 due to potential limitations on its ability to issue securities without Federal Energy Regulatory Commission approval. That issue has since been resolved favorably, and the "review" has been terminated.

Finally, as noted at the outset, it is not the purpose of this letter to address issues relating to the second quarter earnings announcement by PWCC, but we have provided some information in a separate letter from Don Brandt and will provide more detail in the pending general rate case.

Sincerely,

Jack E. Davis

cc: Brian McNeil
Ernest Johnson
Christopher Kempley
Lyn Farmer
Heather Murphy
Parties of Record
Docket Control