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Arizona Corporation Commission
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November 28, 2006

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

Re: Arizona Public Service Company General Rate Case
Docket Nos. E-01345A-05-0816, E-01345A-05-0826, E-01345A-05-0827

Dear Chairman Hatch-Miller:

This is in response to your letter dated October 24, 2006, wherein you requested that APS address several inquiries, most of which aim at exploring how the Company will meet its obligations to serve its rapidly growing customer base in a fiscally prudent and economically sound manner. As your letter indicates, APS faces a host of arduous challenges over the next several years. Your concerns about:

1. system reliability,
2. power supply adequacy,
3. the ability to meet load growth,
4. the maintenance of or improvement of credit ratings, and
5. APS' ability to earn its allowed return on equity,

highlight the serious issues that confront APS.

RESOURCE PLANNING AND ACQUISITION ISSUES

Without a doubt, APS' service territory continues to experience robust growth in energy needs. By 2020, APS projects customer load requirements will increase by 4,000 MWs over the 2006 peak load. After accounting for system reserve requirements and the expiration of existing Power Purchase Agreements (PPAs), APS will need approximately 5,500 MWs of new resources to meet these projected demands.

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APS expects to meet this large resource need through a diverse set of future resource additions including Demand Side Management programs, renewable energy resources, PPAs with merchant generators and, if appropriate, new peaking and base load generation. As part of the resource acquisition process, APS is currently in the process of evaluating bids from a base load RFP which was issued in January, 2006. A decision on the final selection is expected in the first or second quarter of 2007. Additionally, APS has a request before the Commission to allow for self-build of peaking capacity in Yuma with an in-service date prior to the summer of 2008.

Your letter raises another important issue that the affected parties had attempted to resolve in past proceedings: the limited self-build moratorium. The Company believes that the intent of the moratorium, which is predominantly to ensure that APS engages the competitive wholesale market in its resource acquisition efforts, is constructive, and APS wholeheartedly embraces that objective. APS has seen this provision work effectively for the Company's customers in the past year with the procurement of approximately 1,300 MW of long-term resources through the Renewable and Reliability RFPs. However, there may be circumstances where the most beneficial, perhaps even the only, procurement falls into the category of "self-build." "Self-build" necessitates that APS seek approval from the Commission prior to making any resource commitments either on the Company's own behalf or in furtherance of a merchant turn-key project. To assure continued reliable service, in these instances the Commission must strive to make this approval process as timely as possible.

Investment in transmission assets will accompany many of these future resource additions. Moreover, because APS cannot locate many of these resources close to the Phoenix metropolitan area, we will make substantial new investments in transmission facilities to move the remotely-generated power to the load consuming areas. APS' filed 10-year Transmission Plan describes the currently scheduled in-state transmission lines, and this plan will be updated annually as new projects are identified. In addition, the Company has previously advised the Commission of its involvement in the development of the TransWest Express Project, a Wyoming to Arizona line that could bring power from coal and renewable resources to the Southwest.

APS' Vice President of Planning, Mr. Don Robinson will be available to testify about resource planning issues during the latter part of the week of December 4th should the Commissioners or any of the parties have resource planning related questions.

FINANCIAL ISSUES

Underlying, and intertwined with all of these issues, remains the inescapable fact that APS must invest heavily in critical infrastructure over the next 10-year period. APS must budget $14.7 billion in capital expenditures over the 2007 through 2016 timeframe alone, including $4.4 billion over just the next five years. These capital expenditure amounts reflect the additional generation resources that APS customers will require, for which APS must have the financial strength to shoulder the burden of $6 billion, whether by direct APS investment or investment by merchant power generators on behalf of

APS (for which the credit rating agencies impute a debt obligation). Already planned Arizona-based transmission assets, excluding any TransWest Express commitments (which alone could total between $1 billion and $2 billion), will surpass $2 billion over those 10 years. Financings in the capital markets of up to $8 billion will only add to these increasing financial pressures. Of necessity, APS' capital expenditure program, and its ability to finance the program in the capital markets is highly dependent on the adequacy of rate levels

In order for APS to meet its service obligations and to serve its customer base efficiently, the Company must work together with the Commission and other affected parties to improve APS' creditworthiness. As APS has stated consistently throughout the last several regulatory proceedings, the credit rating agencies (Standard & Poor's and Moody's), examine our financial ratios, business results and regulatory environment before assigning a rating to APS debt. Access to capital markets and our interest costs, a significant component of the cost of service, depend on these ratings. The lower the ratings, the higher costs and the greater the constraints on the Company's ability to serve its customers, and conversely, improved ratings would both reduce the ultimate cost of service to APS customers and allow for greater flexibility in financing the capital additions and improvements necessary to provide that service.

APS will now more specifically respond to the financial issues raised in your letter:

1. Sufficient operational cash flow, as you have termed it in your letter, has a direct effect on the important FFO to Total Debt credit metric. At the end of the day, we have to generate enough cash from our business to pay the costs of capital and construction, and provide the necessary security to the Company's lenders. APS' proposal for the Commission to consider accelerated depreciation would increase cash flow by $50 million per year and correspondingly improve the Company's credit metrics while having no effect on earnings. It would also reduce future customer revenue requirements by providing a dollar-for-dollar reduction of the Company's future rate base for which customers would have to provide a return on and a return of capital.

2. Construction Work In Progress (CWIP) in rate base could constitute another element in a sound regulatory foundation. Should the Commission allow the inclusion of CWIP in rate base, APS would benefit from additional cash flow which, in turn, would help to finance the Company's massive construction program. This, too, would have no material effect on earnings because APS would reduce by a similar amount its allowance for funds used during construction ("AFUDC"). Similar to accelerated depreciation, and for the same reasons, inclusion of CWIP reduces future customer revenue requirements.

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3. Granting APS an attrition adjustment designed to mitigate the earnings erosion due to the lag in recovering capital expenditures in a period of higher per customer costs would benefit the Company and its customers in a number of ways:

   a. Initially, it would signal to the rating agencies a supportive regulatory environment.

   b. Secondly, APS would have a reasonable opportunity (still far from a guarantee) to earn its allowed return on equity.

   c. Thirdly, potential equity investors would recognize the improvement in our ROE status and demonstrate a greater willingness to purchase our offerings of equity on reasonable terms.

In light of the magnitude of the Company's construction program, we must have cost-effective access to the equity markets to maintain a reasonably balanced capital structure. If not, the rating agencies will use that fact alone to plunge APS into junk territory. Equity investors always examine a Company's ROE and gain comfort from the higher interest coverage ratios that flow from a higher ROE. By the same token, equity investors know of a regulated utility's recent history of under-earning its allowed ROE, and, as Mr. Brandt explained in his testimony several weeks ago, APS has substantially under-earned its current allowed ROE over the last several years. The amount of under-earnings was shown in Mr. Brandt's rebuttal testimony, Attachment DEB-10RB, page 4. This arises from the earnings attrition resulting from the Company's significant capital expenditure obligations, which attrition occurs despite additional sales growth. As demonstrated in APS Exhibit 59, submitted on November 3, 2006, the required investment per customer in the 2007-2008 timeframe is nearly double the amount currently reflected in the test year.

You inquired in your letter if APS would be able to attain its authorized ROE, excluding cost recovery for fuel and purchased power. The answer is no. Even with timely recovery of fuel and purchased power costs though the PSA, the cost of new construction exceeds the annual revenue from customer growth. Attachment 1 to this letter, which was prepared in response to an earlier request from Commissioner Gleason, shows that the annual non-fuel related revenue from growth is some $86 million short of the annual increase in revenue requirement needed to meet that customer demand.

Regulatory lag compounded by the magnitude of our construction program has in the past, as it will in the future, virtually guarantee that APS will be unable to earn its allowed ROE. An attrition adjustment would help remedy the serious issues that flow from a massive construction program attributable to a relentlessly growing service territory.

None of these proposals, previously discussed in the Company's response to your July 2006 letter and in consideration of the revenue requirement recommendations of Staff and RUCO (which call for a

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reduction in rates exclusive of fuel), is unique either to regulation in general or to Arizona regulation in particular. The Commission has allowed both CWIP and attrition allowances in prior APS rate decisions. Accelerated amortization of some $1.3 billion in regulatory assets (very analogous to our suggestion for accelerated depreciation of tangible assets, albeit on a larger scale) was a cornerstone of the 1996 settlement agreement approved by Decision No. 59601 (April 24, 1996). Even an adjustment to "fair value" rate base is solidly grounded in Arizona precedent, which clearly indicates that there is no specific formula required in the determination of "fair value" and that the cost of capital as applied to original cost is a floor for the required return on "fair value," not a ceiling.

As you note in your letter, even with the benefit of these regulatory and financial tools, we may not satisfy the rating agencies should the Company not have the ability to recover our fuel and purchased power costs in a timely manner. The rating agencies, unfortunately, look very closely at overall financial performance, and give little leeway to companies that rapidly accrue large amounts of costs which require expensive financing prior to recovery.

APS' Executive Vice President and Chief Financial Officer, Mr. Brandt, will testify during the latter part of the week of December 4th and will be available to respond to any of the above financial matters.

Sincerely,

Thomas L. Mumaw

Thomas L. Mumaw

TLM/na
Enclosure
cc: William A. Mundell, Commissioner
Mike Gleason, Commissioner
Kristin K. Mayes, Commissioner
Barry Wong, Commissioner
Parties of Record

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ARIZONA PUBLIC SERVICE COMPANY
Revenue Growth Vs. Growth in Capital Related Costs

Exhibit Description: This exhibit is APS' analysis of how annual non-fuel revenue from customer growth under the current Staff proposal compares to the annual non-fuel revenue requirement due to forecast construction expenditures. This analysis shows that the total annual non-fuel revenue requirement due to forecast construction of $150 million is significantly greater than the total annual non-fuel revenue from customer growth of $64 million resulting in an annual non-fuel revenue shortfall of $86 million. In summary, revenue growth fails to meet the additional revenue requirement.

	Forecast Avg. Annual Number of New Customers 2007 - 2008		Annual Rev. [1] Per Cust. from Staff's Proposed Rates Net of Fuel		Est. Annual Rev. from Cust. Growth (Millions)	Est. Annual Rev. [2] from Cust. Growth Per Avg. Ann. MW Growth (Dollars per MW)
Annual Non-Fuel Revenue from Customer Growth						
Residential	39,864	x	$ 948	=	$ 38	
General Service	4,346	x	$ 5,967	=	$ 26	
Total Annual Revenue from Customer Growth					$ 64	$ 261,224

	Forecast Avg. Annual Construction 2007 - 2008 (Millions)		Revenue Requirement Factors		Annual Rev. Req. of Construction with Staff's Cost of Cap. (Millions)	Annual Rev. Req. of [2] Construction with Staff's Cost of Cap. Per Avg. Ann. MW Growth (Dollars per MW)
Annual Non-Fuel Rev. Req. Due to Forecast Construction [3]						
Property Tax	$ 910	x	1.14% [4]	=	$ 10	
Depreciation	$ 910	x	2.80% [5]	=	$ 25	
Interest	$ 910	x	3.41% [6]	=	$ 31	
Staff's Weighted Cost of Equity	$ 910	x	5.59% [7]	=	$ 51	
Income Tax Gross Up on Equity	$ 910	x	3.58% [7]	=	$ 33	
Total Annual Rev. Req. due to Forecast Construction					$ 150	$ 612,245
Revenue Shortfall [8]					$ (86)	$ (351,020)

[1] The annual non-fuel revenue per customer was derived by subtracting Staff's proposed base fuel amount of $0.027975/kWh from the average non-fuel revenue per kWh for the residential class ($0.09606/kWh) and the E-32 rate for the general service class ($0.08455/kWh) based on the proposed revenue increase of 9.0% shown on Staff Witness Dittmer's Surrebuttal Testimony, Pg. 23. E-32 was used because most of the Company's new general service customers will be on this rate. The energy consumption used in this analysis is the test year residential consumption of 12,362,652 MWhs (13,946 annual kWh per customer) and general service consumption of 10,879,043 MWhs (105,385 annual kWh per customer) per APS S.F.R. Schedule H-2.

[2] Calculation is based on the 2007 - 2008 average annual weather normalized peak demand growth of 245 MWs.

[3] O&M was not included.

[4] Estimated Property Taxes for 2007 divided by Total Utility Plant from 2005 FERC Form 1.

[5] The depreciation rate shown is a weighted average rate. The rate was derived by applying the Foster & Associates 2005 Technical Update depreciation rates that were included in APS witness Dr. Ronald White's Direct Testimony (Attachment REW-1, Pg. 3, Present Accrual Rates) to the 2007 - 2008 forecast construction costs.

[6] Based on 7.5% marginal cost of debt and a 45.5% debt and 54.5% equity capital structure.

[7] Based on Staff's proposed 10.25% cost of equity and a 45.5% debt and 54.5% equity capital structure.

[8] $26 million of the $86 million revenue shortfall is associated with Transmission Plant.