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February 16, 2007

Arizona Corporation Commission  
**DOCKETED**

**FEB 16 2007**

Mike Gleason  
Commissioner  
ARIZONA CORPORATION COMMISSION  
1200 West Washington  
Phoenix, Arizona 85007-2996

DOCKETED BY	XX
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Re: APS Funds From Operations  
(Docket Nos. E-01345A-05-0816, E-01345A-05-0826 & E-01345A-05-0827)

Dear Commissioner Gleason:

The methodology for calculating the Funds From Operations to Debt Ratio ("FFO/Debt") essentially takes cash funds generated from operations and divides that figure by the sum of balance sheet debt plus rating agency imputed debt (e.g., PPAs and certain types of leases). It was discussed in general terms by Mr. Brandt during his testimony on December 5, 2006. (See Tr. Vol. XXIV at 4575-77 [Brandt]).

The formula and financial calculations behind Attachment DEB-2 from the January 31, 2006 Direct Testimony of Donald E. Brandt was contained on Workpaper DEB\_WP21, a copy of which is attached. Although this particular Workpaper was never marked as an exhibit in the above proceeding, it was filed with the Company's Application, made available to the parties and provided to Staff and the Commission. I would note that the projections in Attachment DEB-2 assumed no base rate increase, and were done prior to the enactment by the Commission of the 7 mill Interim PSA Adjustor and the Annual PSA Adjustor (then 4 mills) being moved to February. They were also reflective of the methodology used by Standard and Poors ("S&P") at the time, but which was slightly modified later in 2006.

Updated FFO/Debt ratios were filed with Mr. Brandt's Rebuttal Testimony in September of 2006 as Attachment DEB-2RB. The calculations behind DEB-2RB can be seen on Workpaper DEB\_WP2RB, which is also attached and was provided Staff and other parties at the time Mr. Brandt's Rebuttal Testimony was filed. These FFO/Debt ratios reflected Staff's proposed base rate increase, the 7 mill Interim PSA Adjustor, and the Annual PSA Adjustor effective in February of 2006.

APS • APS Energy Services • SunCor • El Dorado • Pinnacle West Marketing & Trading, Co., LLC

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They also reflected S&P methodology changes since January 2006 for calculating such ratios. Therefore, they are a better indicator of what the Company would look like than the projections filed in January 2006.

I hope this letter has been responsive to your inquiry. Please do not hesitate to request any additional information or clarifications of information that you and the other Commissioners believe is relevant to your decision-making process.

Sincerely,



Thomas L. Mumaw

TLM/

cc: Jeff Hatch-Miller, Chairman  
William A. Mundell, Commissioner  
Kristin K. Mayes, Commissioner  
Gary Pierce, Commissioner  
Lyn A. Farmer, Chief Administrative Law Judge  
Parties of Record

**Income Statement**  
**Present Base Rates with PSA**  
**(\$000)**

DEB\_WP21

	Year 2005	Year 2006	Year 2007
<b>APS</b>	Projected		
<b>REVENUES</b>	<u>\$ 2,292,361</u>	<u>\$ 2,533,439</u>	<u>\$ 2,680,704</u>
<b>Total Cost of Revenues</b>	<u>697,213</u>	<u>911,809</u>	<u>1,040,116</u>
<b>GROSS MARGIN</b>	<u>1,595,148</u>	<u>1,621,630</u>	<u>1,640,588</u>
<b>OTHER OPERATING EXPENSES</b>			
Operations & Maintenance	596,130	654,285	726,581
Depreciation & Amortization (a)	465,574	352,104	377,099
Other Taxes	<u>125,102</u>	<u>142,487</u>	<u>154,690</u>
<b>Total Other Operating Expenses</b>	<u>1,186,806</u>	<u>1,148,876</u>	<u>1,258,370</u>
<b>INTEREST AND OTHER EXPENSES</b>			
Interest Expense	153,084	165,195	190,157
AFUDC Debt / Capitalized Interest	(7,780)	(7,029)	(8,010)
AFUDC Equity	(10,948)	(10,063)	(11,467)
Other (Income) Subtotal	(20,180)	(10,232)	(12,198)
Other Expense Subtotal	13,564	12,998	18,735
<b>INCOME BEFORE INCOME TAXES</b>	<u>280,603</u>	<u>321,885</u>	<u>205,001</u>
<b>INCOME TAXES</b>	<u>103,149</u>	<u>121,162</u>	<u>73,856</u>
<b>NET INCOME</b>	<u>\$ 177,453</u>	<u>\$ 200,723</u>	<u>\$ 131,145</u>

(a) \$138,562 track B write-off shown on depreciation as a non-cash expense

**FFO & Net Cash Flow Ratios**  
**Present Base Rates with PSA**  
**(\$000)**

DEB\_WP21

	Year 2005	Year 2006	Year 2007
<b>APS</b>			
	Projected		
<b>FUNDS FROM OPERATIONS:</b>			
NET INCOME	177,453	200,723	131,145
<b>Plus:</b>			
Depreciation & Amortization (2005 includes \$138,562 track b write-off (non-cash))	465,574	352,104	377,099
Nuclear Fuel	28,474	29,581	30,837
Deferred Tax	(10,868)	22,735	(3,403)
<b>Less:</b>			
Nuc Decom Funding	17,268	19,210	19,210
Deferred Fuel	165,000	48,289	(13,788)
AFUDC Debt / Capitalized Interest	7,780	7,029	8,010
AFUDC Equity	10,948	10,063	11,467
<b>FUNDS FROM OPERATIONS (D)</b>	<b>459,637</b>	<b>520,552</b>	<b>510,779</b>
Common Dividends	170,000	170,000	170,000
<b>NET CASH FLOW</b>	<b>289,637</b>	<b>350,552</b>	<b>340,779</b>
<b>CAPITAL EXPENDITURES:</b>			
Construction Expenditures	804,892	644,043	710,052
Capitalized Property Taxes	5,634	4,508	4,970
<b>Constr. Exp. + Cap. Ptax</b>	<b>810,526</b>	<b>648,551</b>	<b>715,022</b>
<b>ADJUSTED TOTAL DEBT:</b>			
Long Term Debt	2,432,273	2,680,976	3,235,015
Current Maturities of Long-Term Debt	134,942	51,247	51,247
Short-term Debt		261,172	97,206
Palo Verde Lease Balance	341,899	317,722	291,747
Imputed PPA Debt on SRP T&C	150,000	148,000	148,000
Imputed PPA Debt - New			152,209
<b>Adjusted Total Debt (E)</b>	<b>3,059,114</b>	<b>3,459,117</b>	<b>3,975,423</b>
<b>2 PT. Avg. Total Debt (F)</b>	<b>3,114,450</b>	<b>3,259,115</b>	<b>3,717,270</b>
<b>S&amp;P BENCHMARKS</b>			
<b>ADJ. TOTAL DEBT / TOTAL CAPITAL (E / G)</b>	<b>50.1%</b>	<b>53.3%</b>	<b>56.9%</b>
<b>FFO / ADJUSTED AVG. TOTAL DEBT (D / F)</b>	<b>14.8%</b>	<b>16.0%</b>	<b>13.7%</b>
ADJUSTED TOTAL DEBT with imputed debt	3,059,114	3,459,117	3,975,423
PREFERRED EQUITY			
COMMON EQUITY	3,052,590	3,029,313	3,005,458
<b>ADJ. TOTAL CAPITAL (G)</b>	<b>6,111,704</b>	<b>6,488,430</b>	<b>6,980,881</b>

**Coverage Ratio  
Present Base Rates with PSA  
(\$000)**

DEB\_WP21

	Year 2005	Year 2006	Year 2007
<b>APS</b>			
	Projected		
FUNDS FROM OPERATIONS (D)	459,637	520,552	510,779
Interest Expense	153,084	165,195	190,157
PV2 S/L Imputed Interest (S&P method)	35,873	33,633	31,165
Imputed PPA Interest on SRP T&C	15,000	14,800	14,800
Imputed PPA Interest - New			15,221
<b>ADJ. FUNDS FROM OPERATIONS (X)</b>	<b>663,593</b>	<b>734,180</b>	<b>762,121</b>
<b>FIXED CHARGES:</b>			
Interest Expense	153,084	165,195	190,157
PV2 S/L Imputed Interest (S&P method)	35,873	33,633	31,165
Imputed PPA Interest on SRP T&C	15,000	14,800	14,800
Imputed PPA Interest - New			15,221
<b>FIXED CHARGES (Z)</b>	<b>203,957</b>	<b>213,628</b>	<b>251,342</b>
<b>ADJ. FFO INTEREST COVERAGE (X/Z)</b>	<b>3.3</b>	<b>3.4</b>	<b>3.0</b>
Return on Equity	6.8%	6.6%	4.3%

**Income Statement**  
**Staff Proposal with Prospective PSA Adjustor**  
**(\$000)**

DEB\_WP2RB

<b>APS</b>	Year 2006	Year 2007	Year 2008
<b>REVENUES</b>	<u>2,662,730</u>	<u>2,931,681</u>	<u>3,127,102</u>
<b>TOTAL COST OF REVENUES</b>	<u>966,502</u>	<u>1,124,687</u>	<u>1,244,363</u>
<b>GROSS MARGIN</b>	<u>1,696,228</u>	<u>1,806,995</u>	<u>1,882,739</u>
<b>OTHER OPERATING EXPENSES</b>			
Operations & Maintenance	671,651	775,045	807,194
Depreciation & Amortization	352,608	376,495	394,888
Other Taxes	<u>136,391</u>	<u>147,870</u>	<u>159,985</u>
<b>Total Other Operating Expenses</b>	<u>1,160,650</u>	<u>1,299,410</u>	<u>1,362,067</u>
<b>INTEREST AND OTHER EXPENSES</b>			
Interest Expense	163,269	193,529	225,487
AFUDC Debt / Capitalized Interest	(6,764)	(9,173)	(10,345)
AFUDC Equity	(12,687)	(13,131)	(14,810)
Other (Income) Subtotal	(25,130)	(10,552)	(4,077)
Other Expense Subtotal	14,370	18,735	17,192
<b>INCOME BEFORE INCOME TAXES</b>	<u>402,520</u>	<u>328,177</u>	<u>307,225</u>
<b>INCOME TAXES</b>	<u>146,246</u>	<u>117,517</u>	<u>108,851</u>
<b>NET INCOME</b>	<u>256,274</u>	<u>210,659</u>	<u>198,374</u>

**Income Statement**  
**Staff Proposal with Prospective PSA Adjustor**  
**(\$000)**

DEB\_WP2RB

	Year 2006	Year 2007	Year 2008
<b>APS</b>			
<b>FUNDS FROM OPERATIONS</b>			
NET INCOME	256,274	210,659	198,374
Depreciation & Amortization	352,608	376,495	394,888
Nuclear Fuel	29,402	40,714	43,237
Deferred Tax	(16,869)	(23,345)	(34,076)
Deferred Fuel	8,571	85,190	89,749
Interest on Deferred Fuel	(8,363)	(8,610)	(2,600)
AFUDC Debt / Capitalized Interest	(6,764)	(9,173)	(10,345)
AFUDC Equity	(12,687)	(13,131)	(14,810)
PV 2 Lease - Imputed Depreciation	28,455	30,132	31,907
Other Operating Leases - Imputed Depreciation	16,236	16,236	16,236
<b>FUNDS FROM OPERATIONS (D)</b>	<b>646,863</b>	<b>705,168</b>	<b>712,561</b>
<b>CAPITAL EXPENDITURES</b>			
Construction Expenditures	648,143	895,389	924,252
Capitalized Property Taxes	4,537	6,268	6,470
<b>Construction Exp. + Capitalized Property tax</b>	<b>652,680</b>	<b>901,657</b>	<b>930,722</b>
<b>ADJUSTED TOTAL DEBT</b>			
Long Term Debt	2,878,800	3,342,839	3,761,956
Current Maturities of Long-Term Debt	1,925	1,925	1,925
Short-term Debt	88,210	94,500	90,796
Imputed PPA Debt SRP	216,890	213,482	212,893
Imputed PPA Debt - 2005 Reliability	-	170,651	162,348
Imputed PPA Debt - New	-	36,140	72,140
Imputed Debt - PV 2 Lease	334,850	305,580	274,586
Imputed Debt - Other Operating Lease	146,080	146,080	146,080
<b>Adjusted Total Debt (E)</b>	<b>3,666,755</b>	<b>4,311,197</b>	<b>4,722,724</b>
<b>S&amp;P BENCHMARKS</b>			
<b>ADJ TOTAL DEBT / TOTAL CAPITAL (E/G)</b>	<b>54.6%</b>	<b>58.1%</b>	<b>59.6%</b>
<b>FFO / ADJUSTED TOTAL DEBT (D/E)</b>	<b>17.6%</b>	<b>16.4%</b>	<b>15.1%</b>
ADJUSTED TOTAL DEBT (Includes Imputed Debt)	3,666,755	4,311,197	4,722,724
PREFERRED EQUITY			
COMMON EQUITY	3,053,200	3,108,859	3,197,233
<b>ADJ TOTAL CAPITAL (G)</b>	<b>6,719,955</b>	<b>7,420,057</b>	<b>7,919,957</b>

**Income Statement**  
**Staff Proposal with Prospective PSA Adjustor**  
**(\$000)**

DEB\_WP2RB

	Year 2006	Year 2007	Year 2008
<b>APS</b>			
<b>FUNDS FROM OPERATIONS (D)</b>	<b>646,863</b>	<b>705,168</b>	<b>712,561</b>
Interest Paid	152,940	193,197	225,602
Imputed PPA Interest - SRP	12,797	12,595	12,561
Imputed PPA Interest - 2005 Reliability	-	10,068	9,579
Imputed PPA Interest - New	-	2,132	4,256
Imputed Interest - PV 2 Lease	20,545	18,868	17,093
Imputed Interest - Other Operating Lease	8,264	8,264	8,264
PV 2 Lease - Imputed Depreciation	(28,455)	(30,132)	(31,907)
Other Operating Leases - Imputed Depreciation	(16,236)	(16,236)	(16,236)
<b>ADJ. FUNDS FROM OPERATIONS (X)</b>	<b>796,717</b>	<b>903,925</b>	<b>941,771</b>
<b>FIXED CHARGES:</b>			
Interest Expense	163,269	193,529	225,487
Imputed PPA Interest - SRP	12,797	12,595	12,561
Imputed PPA Interest - 2005 Reliability	-	10,068	9,579
Imputed PPA Interest - New	-	2,132	4,256
Imputed Interest - PV 2 Lease	20,545	18,868	17,093
Imputed Interest - Other Operating Lease	8,264	8,264	8,264
<b>FIXED CHARGES (Z)</b>	<b>204,874</b>	<b>245,457</b>	<b>277,239</b>
<b>ADJ. FFO INTEREST COVERAGE (X/Z)</b>	<b>3.9</b>	<b>3.7</b>	<b>3.4</b>
<b>RETURN ON EQUITY</b>	<b>8.5%</b>	<b>6.8%</b>	<b>6.3%</b>