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Thomas L. Mumaw
Senior Attorney
(602) 250-2052
Direct Line

February 16, 2007

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

Arizona Corporation Commission
DOCKETED

FEB 16 2007

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KK

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

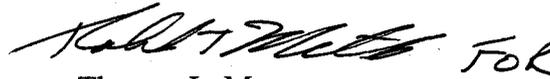
Law Department, 400 North Fifth Street, Mail Station 8695, Phoenix, AZ 85004-3992
Phone: (602) 250-2052 • Facsimile (602) 250-3393
E-mail: Thomas.Mumaw@pinnaclewest.com

Mike Gleason
Commissioner
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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
APS	Projected		
REVENUES	<u>\$ 2,292,361</u>	<u>\$ 2,533,439</u>	<u>\$ 2,680,704</u>
Total Cost of Revenues	<u>697,213</u>	<u>911,809</u>	<u>1,040,116</u>
GROSS MARGIN	<u>1,595,148</u>	<u>1,621,630</u>	<u>1,640,588</u>
OTHER OPERATING EXPENSES			
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>
Total Other Operating Expenses	<u>1,186,806</u>	<u>1,148,876</u>	<u>1,258,370</u>
INTEREST AND OTHER EXPENSES			
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
INCOME BEFORE INCOME TAXES	<u>280,603</u>	<u>321,885</u>	<u>205,001</u>
INCOME TAXES	<u>103,149</u>	<u>121,162</u>	<u>73,856</u>
NET INCOME	<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
APS	Projected		
FUNDS FROM OPERATIONS:			
NET INCOME	177,453	200,723	131,145
Plus:			
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)
Less:			
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
FUNDS FROM OPERATIONS (D)	459,637	520,552	510,779
Common Dividends	170,000	170,000	170,000
NET CASH FLOW	289,637	350,552	340,779
CAPITAL EXPENDITURES:			
Construction Expenditures	804,892	644,043	710,052
Capitalized Property Taxes	5,634	4,508	4,970
Constr. Exp. + Cap. Ptax	810,526	648,551	715,022
ADJUSTED TOTAL DEBT:			
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
Adjusted Total Debt (E)	3,059,114	3,459,117	3,975,423
2 PT. Avg. Total Debt (F)	3,114,450	3,259,115	3,717,270
S&P BENCHMARKS			
ADJ. TOTAL DEBT / TOTAL CAPITAL (E / G)	50.1%	53.3%	56.9%
FFO / ADJUSTED AVG. TOTAL DEBT (D / F)	14.8%	16.0%	13.7%
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
ADJ. TOTAL CAPITAL (G)	6,111,704	6,488,430	6,980,881

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

DEB_WP21

	Year 2005	Year 2006	Year 2007
APS	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
ADJ. FUNDS FROM OPERATIONS (X)	663,593	734,180	762,121
FIXED CHARGES:			
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
FIXED CHARGES (Z)	203,957	213,628	251,342
ADJ. FFO INTEREST COVERAGE (X/Z)	3.3	3.4	3.0
Return on Equity	6.8%	6.6%	4.3%

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

DEB_WP2RB

APS	Year 2006	Year 2007	Year 2008
REVENUES	<u>2,662,730</u>	<u>2,931,681</u>	<u>3,127,102</u>
TOTAL COST OF REVENUES	<u>966,502</u>	<u>1,124,687</u>	<u>1,244,363</u>
GROSS MARGIN	<u>1,696,228</u>	<u>1,806,995</u>	<u>1,882,739</u>
OTHER OPERATING EXPENSES			
Operations & Maintenance	671,651	775,045	807,194
Depreciation & Amortization	352,608	376,495	394,888
Other Taxes	136,391	147,870	159,985
Total Other Operating Expenses	<u>1,160,650</u>	<u>1,299,410</u>	<u>1,362,067</u>
INTEREST AND OTHER EXPENSES			
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
INCOME BEFORE INCOME TAXES	<u>402,520</u>	<u>328,177</u>	<u>307,225</u>
INCOME TAXES	<u>146,246</u>	<u>117,517</u>	<u>108,851</u>
NET INCOME	<u>256,274</u>	<u>210,659</u>	<u>198,374</u>

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

DEB_WP2RB

APS	Year 2006	Year 2007	Year 2008
FUNDS FROM OPERATIONS			
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
FUNDS FROM OPERATIONS (D)	646,863	705,168	712,561
 CAPITAL EXPENDITURES			
Construction Expenditures	648,143	895,389	924,252
Capitalized Property Taxes	4,537	6,268	6,470
Construction Exp. + Capitalized Property tax	652,680	901,657	930,722
 ADJUSTED TOTAL DEBT			
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
Adjusted Total Debt (E)	3,666,755	4,311,197	4,722,724
 S&P BENCHMARKS			
ADJ TOTAL DEBT / TOTAL CAPITAL (E/G)	54.6%	58.1%	59.6%
FFO / ADJUSTED TOTAL DEBT (D/E)	17.6%	16.4%	15.1%
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
ADJ TOTAL CAPITAL (G)	6,719,955	7,420,057	7,919,957

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

DEB_WP2RB

	Year 2006	Year 2007	Year 2008
APS			
FUNDS FROM OPERATIONS (D)	646,863	705,168	712,561
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)
ADJ. FUNDS FROM OPERATIONS (X)	796,717	903,925	941,771
FIXED CHARGES:			
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
FIXED CHARGES (Z)	204,874	245,457	277,239
ADJ. FFO INTEREST COVERAGE (X/Z)	3.9	3.7	3.4
RETURN ON EQUITY	8.5%	6.8%	6.3%