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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND TO AMEND DECISION NO. 67744.	Docket Nos. E-01345A-05-0816 E-01345A-05-0826 E-01345A-05-0827 **EXCEPTIONS**

The Arizona Investment Council ("AIC"), formerly known as the Arizona Utility Investors Association,[1] submits these exceptions to the recommendation of the Chief Administrative Law Judge ("CALJ") dated April 27, 2007 ("ROO"). The AIC and its nearly 7,000 members commend the CALJ on certain aspects of the ROO, including its recommendation to approve Staff's "forward looking" PSA.

If, however, the ROO is approved without further amendment, more than ample evidence demonstrates that APS will not be able to attract, on reasonable terms, the massive amount of capital required to meet the needs of the nation's fastest growing state and likely will suffer a downgrade of its long-term debt rating to "junk" status. That result obviously benefits neither investors nor customers. To attempt to avoid it, the AIC focuses these exceptions on two issues designed to improve modestly the quantity and the quality of APS' earnings: (1) a 1.7% return

[1] In April 2007, the AIC amended its articles of incorporation to change its name to the Arizona Investment Council, reflecting its expanded mission and emphasis on infrastructure and capital needs generally in our state, including those of its utility members and investors.

GALLAGHER & KENNEDY, P.A.
2575 E. CAMELBACK ROAD
PHOENIX, ARIZONA 85016-9225
(602) 530-8000

on equity ("ROE") attrition allowance and (2) construction work in progress ("CWIP") and accelerated depreciation allowances.

Candidly, the AIC believes rate relief in addition to these two recommendations is required and fully justified—particularly in light of APS' perilous financial circumstances and $900 million annual capital expenditure budget. For example, the ROO's recommended 10.75% ROE remains at the low end of what AIC witness Julie Cannell testified was the range of investors' reasonable expectations.[2] Its only slight improvement in the recovery of APS' non-fuel cost of service likely is not sufficient, as one investment analyst noted, "to maintain investment grade ratings or provide support for the current stock value."[3] Given the facts, among others, that APS has increased its rate base by $1 billion and infused $450 million in new equity since its last 2002 test year, equity analysts and ratings agencies will understandably view the ROO's only $6 million non-fuel-related rate increase as paltry, at best.

However, AIC also recognizes that the Commission faces a difficult job in balancing the interests of the Company, its shareholders and its more than one million customers. In that spirit, the ROE attrition, CWIP and accelerated depreciation allowances urged here are conservative measures aimed at specific aspects of the current peril. They send a positive regulatory signal, gradually improve APS' creditworthiness and provide tangible ratepayer benefits.

Background

From 1995 to 2005, APS decreased rates by some $1.74 billion, while simultaneously investing $2 billion in new transmission and distribution infrastructure and increasing employee productivity by 32%.[4] For the foreseeable future, however, APS capital needs approach

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[2] AUIA 2, p. 4.
[3] *Id.*, pp. 4-5.
[4] APS 1, p. 3, ll. 15-16; p. 17, ll. 6-9 and 11-13.

$1 billion annually—more than four times the prior decade's pace.[5] Stated another way, APS needs to newly invest each year about 20% of its current $4.4 billion original cost rate base which has been constructed over the past century. Its ability to do so is in grave doubt.

In slightly more than a year, all three credit ratings agencies have downgraded the Company's bond ratings. Standard and Poor's has increased the Company's business risk profile and reduced its credit rating to the final notch above "junk" status. The critical FFO/Debt cash metric remains in non-investment grade territory. Moody's Investor Services has reiterated the possibility of additional downgrades absent supportive action in this case. It maintains a negative outlook on APS—specifically citing the credit challenge of "increasing amounts of capital expenditures" and the need for significant rate increases "to recover costs associated with capital investments as well as increased expenses for fuel and purchased power."[6]

These facts overwhelmingly dictate that there are two problems the Commission must address—not just a stronger PSA, but, as well, a financially stronger APS. While the ROO's adoption of Staff's "forward looking" PSA makes significant progress toward timely recovery of fuel and purchased power costs, its rejection of almost all of the balance of APS' request is clearly not a significant rate increase and does nothing to meet the credit challenge of increased capital expenditures.

Exceptions

The issue of a financially stronger APS should be addressed in at least two ways. First, the quantity of earnings must be improved. Second, given the fact that APS' cash metric remains below the 18% minimum required to maintain an investment grade rating, earnings quality must also be further strengthened.

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[5] APS Exhibit 27.
[6] AUIA 1, p. 18, ll. 19-21.

A 1.7% ROE attrition allowance will improve earnings quantity, help APS gradually improve its creditworthiness and allow it at least some opportunity to approach the ROO's authorized ROE of 10.75%. The ROO rejects such an allowance, in part because it relies on "projected financial information and assumptions about events that may or may not occur in the future."[7] Placing to one side the fact that ratings agencies will use forecasts to determine, after this order is issued, what to do with APS' credit ratings, considerable historic evidence fully supports the 1.7% attrition allowance as fair and conservative.

Less than 15 months after the 2005 rate decision, APS' actual return on capital was more than 4.5% lower than the authorized ROE. The Company's 2003-2006 actual earnings experience has consistently ranged from 200 to more than 400 basis points below its authorized return. The Commission has previously authorized a much larger explicit attrition adjustment of 4%, when APS' capital requirements were much less and its credit rating was much stronger.[8]

Finally, in response to a question from Commissioner Gleason, Dr. Avera stressed the "psychological" importance and value of an explicit attrition allowance for both investors and the rating agencies:

> [T]he fact that APS is BBB-minus and that the rating agencies in their writings have explicitly said they're concerned about attrition, I think that makes it important for the Commission to send the signal or demonstrate to the rating agencies and all of the investors generally that you understand the problem and are willing to support.[9]

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[7] ROO, p. 62, l. 27.
[8] Wheeler Hearing Testimony, TR Vol. 1, p. 109, l. 11-p. 113, l. 11.
[9] TR Vol. IX, p. 1940, ll. 4-10.

Former Fitch analyst Steve Fetter stated the same conclusion—stressing that the "attrition adjustment may have the best solidifying effect on the credit rating with the potential for improvement."[10]

Twice last year, the Commission took important steps to stop APS' precipitous slide into junk bond territory by authorizing an interim fuel cost adjustor and then continuing it. Those supportive actions were well-received, but the risks clearly have not diminished. Approval of a 1.7% ROE attrition allowance is an absolutely vital step toward minimizing those risks.

Equally important steps are inclusion in the Company's rate base of the actual $261 million CWIP balance as of June 30, 2006 and approval of $50 million per year in allowed depreciation expense. Neither increases earnings, but they do strengthen earnings quality, provide future customer rate reductions, improve APS' critical FFO/Debt ratio and send an additional message to the markets and rating agencies that the Commission supports a balanced approach to improve the Company's financial position.

The ROO declines to adopt these measures because of the stated belief that adoption of the "forward looking" feature and other modifications to the PSA will adequately address the Company's cash flow problems.[11] While AIC does not minimize the importance of these changes, they simply don't adequately address that problem.

With reference to Exhibit APS 5, DEB-2RB, AIC estimates that adoption of the ROO <u>with</u> its PSA modifications will still leave the Company in 2007 more than 1% below the required 18% investment grade minimum of the FFO/Debt metric. The CWIP and accelerated depreciation allowances provide a vital 1.2% improvement in that measure. Finally, no party disputes the fact that both allowances provide reductions in rates for future ratepayers.

[10] TR Vol. VI, p. 1266, ll. 9-12.
[11] ROO, p. 63, ll. 1-17.

The Commission authorized CWIP allowances during the Palo Verde construction years when APS' capital budget was one-third what it is today and its credit rating was in the A range, not knocking on the ratings basement door of BBB minus. Today's credit and earnings quality challenges are even worse in comparison to that period, because federal tax credits and accelerated depreciation are no longer in effect, many small projects instead of one large base-load project create an on-going shortfall in actual revenues to support on-line investment and there is no light at the end of this tunnel as APS is required to meet year after year Arizona's rapid, steady growth. Particularly given the future customer rate benefits these proposals produce, the CWIP and accelerated depreciation allowances are well-balanced, cost-effective ways to address these problems.

Conclusion

At a minimum, the Commission should amend the ROO to include a 1.7% ROE attrition adjustment and CWIP and accelerated depreciation allowances. Arizona needs a stronger APS to meet its growth challenges as well as to take advantage of its growth opportunities. If a stronger APS does not emerge from this case, the losers are not only the Company and investors like AIC's members, but all of its more than one million customers.

RESPECTFULLY SUBMITTED this 15th day of May, 2007.

GALLAGHER & KENNEDY, P.A.

By Michael M. Grant

Michael M. Grant
2575 East Camelback Road
Phoenix, Arizona 85016-9225
Attorneys for Arizona Investment Council
f/k/a Arizona Utility Investors Association

Original and 17 copies filed this 15th day of May, 2007, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Copies of the foregoing delivered this 15th day of May, 2007, to:

Commissioner Mike Gleason, Chairman
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner William A. Mundell
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Jeff Hatch-Miller
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Gary Pierce
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Lyn A. Farmer
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Christopher Kempley
Chief Counsel, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Janice Alward
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Gordon Fox
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copies of the foregoing mailed this
15th day of May, 2007, to:

Thomas L. Mumaw
Pinnacle West Capital Corporation
Post Office Box 53999, MS 8695
Phoenix, Arizona 85072-3999

Scott Wakefield
Residential Utility Consumer Office
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007

Deborah R. Scott
Kimberly A. Grouse
Snell & Wilmer
One Arizona Center
400 East Van Buren
Phoenix, Arizona 85004-2202

Bill Murphy
Murphy Consulting
5401 North 25th Street
Phoenix, Arizona 85016

Douglas V. Fant
Law Offices of Douglas V. Fant
PMB 411
3655 West Anthem Drive, Suite A109
Anthem, Arizona 85086

Dan Austin
Comverge, Inc.
6509 West Frye Road, Suite 4
Chandler, Arizona 85226

Michael Patten
Roshka DeWulf & Patten, P.L.C.
One Arizona Center
400 East Van Buren, Suite 800
Phoenix, Arizona 85004

Jim Nelson
12621 North 17th Place
Phoenix, Arizona 85022
Michelle Livengood
UniSource Energy Services
One South Church Street, Suite 200
Tucson, Arizona 85702

Timothy Hogan
Arizona Center for Law in Public Interest
202 East McDowell Road, Suite 153
Phoenix, Arizona 85004

Tracy Spoon
Sun City Taxpayers Association
12630 North 103rd Avenue, Suite 144
Sun City, Arizona 85351

George Bien-Willner
3641 North 39th Avenue
Phoenix, Arizona 85014

Gary Yaquinto
Arizona Investment Council
2100 North Central Avenue, Suite 210
Phoenix, Arizona 85004

Michael L. Kurtz
Kurt J. Boehm
Boehm, Jurtz & Lowry
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Attorneys for The Kroger Co.

C. Webb Crockett
Patrick J. Black
Fennemore Craig
3003 North Central Avenue, Suite 2600
Phoenix, Arizona 85012-2913
Attorneys for Phelps Dodge Mining Company and
Arizonans for Electric Choice and Competition

Steven B. Bennett
Deputy City Attorney
City of Scottsdale
3939 North Drinkwater Boulevard
Scottsdale, Arizona 85251

Robert W. Geake
Arizona Water Company
Post Office Box 29006
Phoenix, Arizona 85038

Lieutenant Colonel Karen S. White
Chief, Air Force Utility Litigation Team
AFLSA/JACL-ULT
139 Barnes Drive
Tyndall AFB, Florida 32403

Greg Patterson
916 West Adams, Suite 3
Phoenix, Arizona 85007

Lawrence V. Robertson, Jr.
Munger Chadwick, P.L.C.
Post Office Box 1448
Tubac, Arizona 85646-0001
Attorneys for Mesquite Power, L.L.C.,
Southwestern Power Group, II, L.L.C.
and Bowie Power Station, L.L.C.

Andrew W. Bettwy
Southwest Gas Corporation
5241 West Spring Mountain Road
Las Vegas, Nevada 98150

Jay I. Moyes
Moyes Storey
1850 North Central Avenue, Suite 1100
Phoenix, Arizona 85004

Kenneth Saline
160 North Pasadena, Suite 101
Mesa, Arizona 85201

Sean Seitz
3008 North Civic Center Plaza
Scottsdale, Arizona 85251

Amanda Ormond
7650 South McClintock, Suite 103-282
Tempe, Arizona 85284

David Kennedy
818 East Osborn Road, Suite 103
Phoenix, Arizona 85014-0000

Deri Pearsall

18762-3/1556650