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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION  
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Arizona Corporation Commission

DOCKETED

MAY 15 2007

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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,<sup>1</sup> 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

<sup>1</sup> 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.

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

3 Candidly, the AIC believes rate relief in addition to these two recommendations is  
4 required and fully justified—particularly in light of APS’ perilous financial circumstances and  
5 \$900 million annual capital expenditure budget. For example, the ROO’s recommended 10.75%  
6 ROE remains at the low end of what AIC witness Julie Cannell testified was the range of  
7 investors’ reasonable expectations.<sup>2</sup> Its only slight improvement in the recovery of APS’ non-  
8 fuel cost of service likely is not sufficient, as one investment analyst noted, “to maintain  
9 investment grade ratings or provide support for the current stock value.”<sup>3</sup> Given the facts,  
10 among others, that APS has increased its rate base by \$1 billion and infused \$450 million in new  
11 equity since its last 2002 test year, equity analysts and ratings agencies will understandably view  
12 the ROO’s only \$6 million non-fuel-related rate increase as paltry, at best.

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

### 18 **Background**

19 From 1995 to 2005, APS decreased rates by some \$1.74 billion, while simultaneously  
20 investing \$2 billion in new transmission and distribution infrastructure and increasing employee  
21 productivity by 32%.<sup>4</sup> For the foreseeable future, however, APS capital needs approach

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22 <sup>2</sup> AUIA 2, p. 4.

23 <sup>3</sup> *Id.*, pp. 4-5.

24 <sup>4</sup> APS 1, p. 3, ll. 15-16; p. 17, ll. 6-9 and 11-13.

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

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

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

#### 18 **Exceptions**

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

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23 <sup>5</sup> APS Exhibit 27.

24 <sup>6</sup> AUIA 1, p. 18, ll. 19-21.

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

8 Less than 15 months after the 2005 rate decision, APS' actual return on capital was more  
9 than 4.5% lower than the authorized ROE. The Company's 2003-2006 actual earnings  
10 experience has consistently ranged from 200 to more than 400 basis points below its authorized  
11 return. The Commission has previously authorized a much larger explicit attrition adjustment of  
12 4%, when APS' capital requirements were much less and its credit rating was much stronger.<sup>8</sup>

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

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

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22  
23 <sup>7</sup> ROO, p. 62, l. 27.

<sup>8</sup> Wheeler Hearing Testimony, TR Vol. 1, p. 109, l. 11-p. 113, l. 11.

<sup>9</sup> TR Vol. IX, p. 1940, ll. 4-10.

1           Former Fitch analyst Steve Fetter stated the same conclusion—stressing that the “attrition  
2 adjustment may have the best solidifying effect on the credit rating with the potential for  
3 improvement.”<sup>10</sup>

4           Twice last year, the Commission took important steps to stop APS’ precipitous slide into  
5 junk bond territory by authorizing an interim fuel cost adjustor and then continuing it. Those  
6 supportive actions were well-received, but the risks clearly have not diminished. Approval of a  
7 1.7% ROE attrition allowance is an absolutely vital step toward minimizing those risks.

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

14           The ROO declines to adopt these measures because of the stated belief that adoption of  
15 the “forward looking” feature and other modifications to the PSA will adequately address the  
16 Company’s cash flow problems.<sup>11</sup> While AIC does not minimize the importance of these  
17 changes, they simply don’t adequately address that problem.

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

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23 <sup>10</sup> TR Vol. VI, p. 1266, ll. 9-12.

24 <sup>11</sup> ROO, p. 63, ll. 1-17.



1 **Original and 17 copies** filed this  
15<sup>th</sup> day of May, 2007, with:

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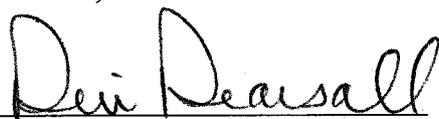
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