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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONERS

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WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

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

DOCKET NO. E-01345A-08-0172

MOTION FOR APPROVAL OF INTERIM RATE AND PRELIMINARY ORDER

(PROCEDURAL CONFERENCE REQUESTED)

To help staunch a growing financial threat to itself and its customers without increasing customer bills beyond current levels, Arizona Public Service Company ("APS" or the "Company") hereby respectfully moves the Arizona Corporation Commission ("Commission") to approve an Interim Base Rate Surcharge of $.003987 per kWh, to be effective upon the expiration of the $.003987 per kWh 2007 PSA adjustor charge ("Interim PSA Charge"), the continuation of which was approved by Decision No. 69663 (June 28, 2007).[1] Such Interim Base Rate Surcharge would be subject to refund with interest[2] pending the Commission's final decision in this Docket.

[1] Decision No. 69663 permitted the 2007 Annual PSA Adjustor to continue past January 31, 2008 until an additional $46 million of fuel and purchased power costs were recovered. It is presently anticipated that this PSA charge will "roll-off" in July or early August of 2008.

[2] APS is proposing that its commitment to refund any excess interim revenues serve as the "other arrangements satisfactory to the Commission" as referenced in A.A.C. R14-2-103(B) (11) (h).

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Because the Commission may not be able to make a final ruling on the Company's Motion prior to the "roll-off" of the Interim PSA Charge, APS would ask that the Commission grant the APS Motion on a preliminary basis, again subject to refund, pending such proceedings as the Commission believes necessary. To provide for an expeditious consideration of the Company's request, APS would ask the Commission's Hearing Division to promptly schedule a Procedural Conference to discuss the procedures to be followed for such consideration.

Attached as Exhibits A and B in support of the Motion are the Affidavits of Donald E. Brandt, the Company's President and Chief Executive Officer, and Dr. Charles J. Cicchetti, former Chair of the Wisconsin Public Service Commission and an acknowledged expert in public utility regulation. Attached as Exhibit C is Interim Surcharge Schedule IR-1. The accompanying language for the individual APS rate schedules that reflect the proposed Interim Base Rate Surcharge will be included in any compliance filing should the Commission grant the Company's Motion.

I. INTRODUCTION

As of May 31, 2008, APS has already expended over $1.7 billion for new facilities that are not reflected in current rates. And the costs of additional planned or underway projects are very substantial and increasing. In fact, APS is facing increased infrastructure costs that are spiraling upward on literally a monthly basis. The effect of these price increases on APS's construction costs (and thus its capital requirements) is striking, as discussed in more detail later in this Motion. It is precisely the higher costs of owning and operating such infrastructure investment that APS is seeking to partially recover, on an interim basis, through the requested Interim Base Rate Surcharge. And the costs of the basic infrastructure required for essential electric system operations do not include some of the more high-tech and innovative projects that APS has planned.

For examples of the latter, APS has begun implementing a series of new programs intended to improve customer service and reliability and to set the stage for technological innovation, while allowing additional customer choice and control over their energy usage. In that regard, the Company has already achieved one of the highest rates of implementation of full, two-way Advanced Metering Infrastructure ("AMI") of any investor-owned utility nationwide, and hopes to have completed its roll-out of AMI for all areas of its service territory in which such technology is practicable by the end of 2012. In tandem with other "smart grid" improvements to the Company's current capabilities, these meters will allow APS to better serve its customers through enhanced rate offerings and heightened reliability and, when the technology is fully developed, will provide customers with a greater ability to manage their electricity costs.

The Company is also in the process of employing a Distribution Outage Management System ("DOMS"). DOMS is a state-of-the art software program that will enable the Company to move from a "paper-based" outage management system to an automated one. DOMS will significantly improve the efficiency of identifying and managing system outages. APS has also identified and budgeted for capital improvements to its system on tribal reservations, which will allow APS to continue its recent trend towards securing higher reliability on Native American lands. In addition, the Company continually strives to reduce the environmental footprint of its coal-fired generation plants – beginning with the Cholla Power Plant – such that those plants will meet or exceed all existing and anticipated environmental requirements in the years to come.

But all of these benefits come at a cost – one that is in addition to the more traditional costs that APS must already incur to maintain even its basic electric system in an attempt to ensure continued reliability for the Company's current and future customers. These costs cannot be borne – and thus these important customer-focused programs cannot be economically funded – by a financially unhealthy utility. Sound long-term financial health for APS ultimately and importantly benefits the Company's customers in the form of comparably lower rates, beneficial customer-focused programs, and sustainable and reliable electric service—fundamental necessities in an age of increasing reliance on and demand for electric energy.

Because APS earnings and cash flows are inadequate to finance these new capital needs, APS must borrow huge sums to keep up with the needs of APS customers. But, APS already has debt ratings that are on the last rung above "junk." Only 5 of the 139 investor-owned electric utilities in the nation have credit ratings that are lower than APS's. Mr. Brandt's Affidavit discusses the consequences, already well-known to this Commission, to APS customers of "junk" status. These include higher interest rates and other financing costs that could amount to a billion dollars over the next 10 years. Access to credit markets might be foreclosed in their entirety. Brandt Affidavit at ¶¶ 23-29. There is also a loss of operational and financial flexibility as extensions of vendor credit evaporate and collateral requirements eat up more of what cash is still available from operations. Such consequences make the "cost" of interim relief (which is no more than a phasing in of a portion of APS's requested permanent rate relief) pale by comparison. Thus, APS and its customers are working "without a net," and it is more likely than not that APS could slip off that last rung prior to a final decision in this docket.

And because its prices are far below its costs, APS is also experiencing a very substantial and financially-crippling underearning. If left unaddressed by regulation, underearning is no more than a lay term for "confiscation" – something prohibited by both the United States and Arizona Constitutions. Such underearning is in large part due to the huge requirements for infrastructure additions since the Company's last rate case test period, amounting to some $1.7 billion through May 31, 2008 – much of which is operational and beneficially serving customers today. Granting APS interim rate relief, as requested herein, will allow APS to recover a portion of the costs of owning and operating this additional infrastructure, and such relief clearly would be used for such purpose.

In addition to reducing the funds available for reinvestment in new infrastructure, lower earnings translate into a reduced return on equity ("ROE"). Thus, as is stated in Mr. Brandt's Affidavit, APS's jurisdictional ROE for 2008 is anticipated to be just 8.4%. By 2009, the Company's jurisdictional return falls to a meager 6.3%. Brandt Affidavit at ¶17. Not only are such returns below the 10.75% found reasonable by the Commission less than a year ago, they are below even the lowest ROE (9.25%) proposed by any party in the last APS rate proceeding. They are, in fact, the worst earnings performance by APS in nearly two decades. The cumulative jurisdictional earnings shortfall for 2008 and 2009 totals some $213 million. This means $213 million less to reinvest in facilities to serve customers, which would then need to either be deferred or funded with more borrowing.

APS's internal generation of funds for needed infrastructure to serve customers is expected to be just 71% in 2008 and falls even further to 60% for 2009, absent some rate relief in the interim. In other words, APS is operating at a significant and growing actual and structural "budget deficit" ($422 million in 2007 alone) – something that puts APS and its customers at the mercy of the fickle and often predatory international capital market.

The Amended Application filed in this Docket on June 2, 2008 discusses the need to identify and pursue specific financial and regulatory goals for APS. One of those goals is a systematic move to a "balanced budget" where APS is able to fund from operations all of its normal expenditures, including capital expenditures. The relief sought by this motion would not accomplish that goal, but it would raise some $115 million (pre-tax) per year towards reducing that deficit spending and thus would be a very positive step in the right direction.

With the implementation of the requested surcharge, jurisdictional ROE would rise to 9.4% for 2008 and 8.3% for 2009. Such interim relief would produce an additional $69 million in earnings ($115 million pre-tax) on an annual basis, which would be reinvested in infrastructure and technology necessary to serve APS customers and reduce the need for external debt financing. Although less than half the anticipated earnings shortfall, it would still represent a meaningful improvement over the status quo and significantly reduce by at least 41% the financial impact on customers of a final order in the Company's pending permanent base rate case. And with regard to the Company's remaining capital infrastructure needs, interim relief would relieve significant pressure on the Company's perilously weak credit ratings and allow APS [through Pinnacle West Capital Corporation ("PNW")] to attract needed equity capital.

All of these benefits can be achieved without <u>any</u> increase in APS customer bills compared to what they are already paying today. As noted by both Mr. Brandt and Dr. Cicchetti in their Affidavits, this represents a rare opportunity that once lost cannot be recovered. Brandt Affidavit at ¶9; Cicchetti Affidavit at ¶14. The problem of APS's financial deterioration should not be left to fester and, to paraphrase the words sometimes used as of late during Commission deliberations, simply kicked down the road and dropped into the lap of another Commission. Rather, APS customers can have any rate increase next year significantly ameliorated by implementing an interim base rate surcharge now, at a time when it can be done with no increase in customer bills.

Although, as noted later in this Motion, the Commission need not find the existence of an "emergency" to authorize interim rates (and has, indeed, granted interim rates in the past without any such finding), APS does believe that the threat to APS's credit ratings during the duration of the Company's general rate case would, standing alone and without consideration of the other circumstances discussed below and in the attached Affidavits, constitute a lawful basis for a finding of an "emergency." Thus, the

Commission should not be diverted in its consideration of the APS Motion with a debate over the definition of a concept – "emergency" – that this Commission is fully capable of defining itself in whatever terms it finds appropriate for the circumstances.

Granting interim relief as requested in the Motion is consistent with the Commission's historical recognition that "the benefits of higher bond ratings inure to both the utility and the ratepayer" and therefore that "sound and responsible regulatory action by this Commission is fundamental to the maintenance of desirable bond ratings." Decision No. 51009 (May 29, 1980). The Commission's position in Decision No. 51009 was consistent with that of other leading regulatory bodies. As stated by Dr. Cicchetti: "That said, in my tenure at the PSCW, it quickly became apparent that ... my job as a regulator also entailed keeping and striving to improve the utilities' bond ratings in the state." Cicchetti Affidavit at ¶16.

II. SUMMARY OF MOTION

APS presently has on file an application for permanent base rate relief of $278.2 million, exclusive of the PSA fuel revenues that would simply be reclassified as base revenues under the Company's proposal. *See* Docket No. E-01345A-08-0172. APS is requesting that some $115 million of that request be approved on an interim basis, subject to refund, in the form of a $.003987 per kWh Interim Base Rate Surcharge applicable to the same kWh as are presently subject to the Interim PSA Charge approved in Decision No. 69663. APS's proposal would thus exempt E-3 and E-4 low income customers, E-36 customers, and the solar rate schedules Solar-2 and SP-1 from the Interim Base Rate Surcharge just as they are exempt from the Interim PSA Charge. The Interim Base Rate Surcharge would become effective coincident with the "roll-off" or termination of the Interim PSA Charge, resulting in a zero net change in affected customers' bills. Because there is relatively little time between the filing of this Motion and the scheduled "roll-off" of the Interim PSA Charge, APS asks that the Commission expeditiously consider its

Motion and, as discussed earlier, if additional time is needed for such consideration, grant it on a preliminary basis, with all funds collected thereby to be recorded as a regulatory liability subject to a final ruling on the APS Motion.[3]

Interim rates are a common and vitally important regulatory tool in other jurisdictions. The Commission's authority to grant such interim relief has a solid legal basis in this state, as will be discussed in more detail later in this Motion. The facts in this case: rapidly escalating costs as described herein; a deteriorating financial condition that jeopardizes service and threatens access to needed capital on reasonable terms; and the inability to consider permanent rate relief in sufficient time to prevent severe harm to APS and, under the circumstances presented herein, the Company's customers, are classic bases for authorizing interim rates both in Arizona and elsewhere.

III. FACTS AND LAW IN SUPPORT OF THE MOTION

In support of this Motion, the Company respectfully states:

A. Factual Background

The Company provides electric services in all or part of twelve Arizona counties. It has over one million customers. In order to fulfill its obligation to provide reliable service to its present and future customers, the Company has embarked on a substantial capital expenditure ("CAPX") program to build necessary transmission and distribution lines, generation plant improvements, new environmental control systems, and other service facilities. The Company's present CAPX budget for the year 2008 is over $1 billion, which includes many of the innovative and customer-oriented programs discussed earlier

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[3] By recording any funds received by a preliminary grant of the Company's Motion as a regulatory liability, they would be subject to a full refund or other credit to customers should the Commission eventually deny the Motion after whatever additional proceedings to consider such Motion have been completed. If, on the other hand, the APS Motion were granted, the regulatory liability would be deemed discharged and APS would record the amounts received as revenue pending a final order in this Docket. If at that time, the Commission finds that APS was entitled to less permanent rate relief than was provided through the Interim Base Rate Surcharge, it could order a refund of all or any portion of that difference at that time.

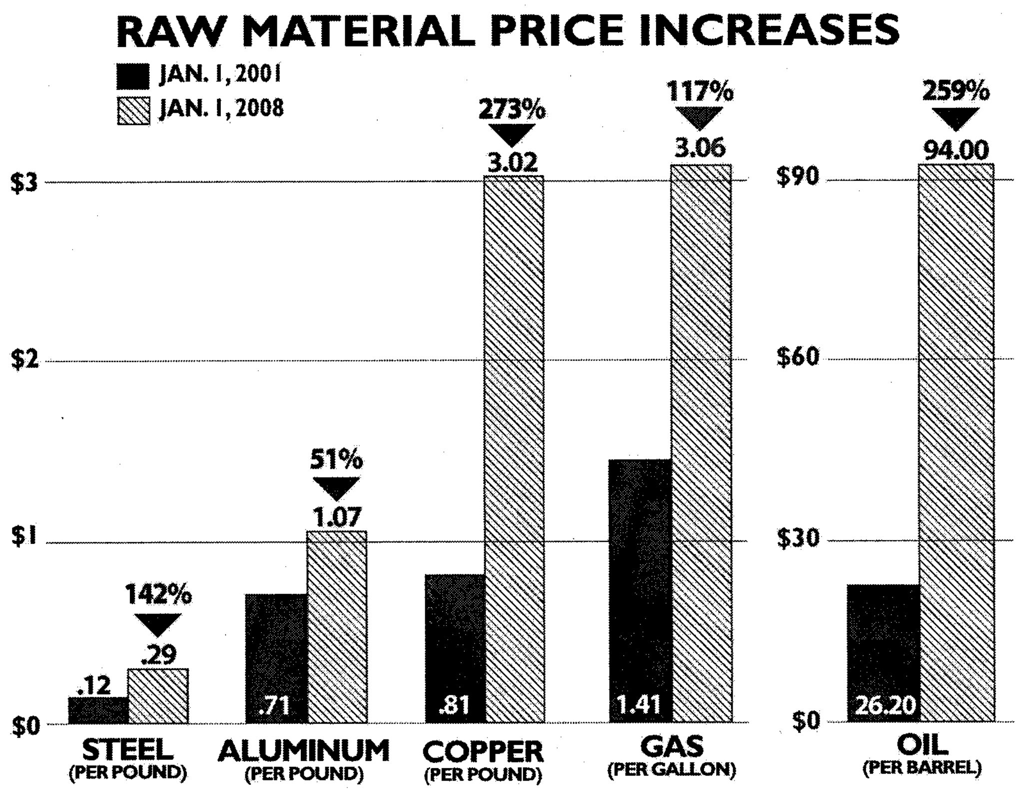
such as AMI, DOMS, etc. Over the years 2008 through 2010, CAPX is anticipated to be approximately $3 billion. This CAPX program, together with the Company's need to refinance existing indebtedness as it matures and the Company's other capital requirements during the same time period, will require the Company to secure over $2 billion from external capital sources, even assuming its pending permanent base rate request is granted in full and by October 1, 2009.

The ability of the Company to raise these funds depends in large measure on its financial vitality, both present and prospective, and the degree to which it is viewed by the financial markets as an investment-worthy enterprise. However, the failure to address the continuing and massive undercollection of capital costs has already undermined the Company's financial health, adversely affected its access to the outside equity capital markets, and threatens the loss of financial integrity in the near term absent interim relief.

B. <u>The Company's Present Financial Condition</u>

APS's distribution and other investment requirements have risen considerably. Thus, while the Company's current and projected customer and demand growth rates are reasonably comparable to those of prior years, APS's distribution, transmission, and generation infrastructure needs to serve those new customers have changed substantially. APS has little margin of capacity available to it now, so it must both expand its distribution and transmission system and upgrade its existing system in order to continue to provide reliable service to its growing customer base.

APS's escalating physical infrastructure and construction needs come at a time when the cost of materials, commodities, and land used for construction is considerably higher than it has been in the past. Each new physical plant addition thus comes at a disproportionately higher cost than it would have almost 10 years ago. These higher costs can only be funded in one of three ways (or a combination thereof): retained earnings of the Company; new debt; and new equity infusions. The first comes solely from the ongoing operations of APS, while the others must come from outside investors. Indeed, as shown in the following table, the prices of copper, steel, aluminum, and gasoline, to name only a few—materials that are vital to APS's construction program—are much more expensive now than they have been historically, and are expected to continue to rise faster than general inflation in the foreseeable future.

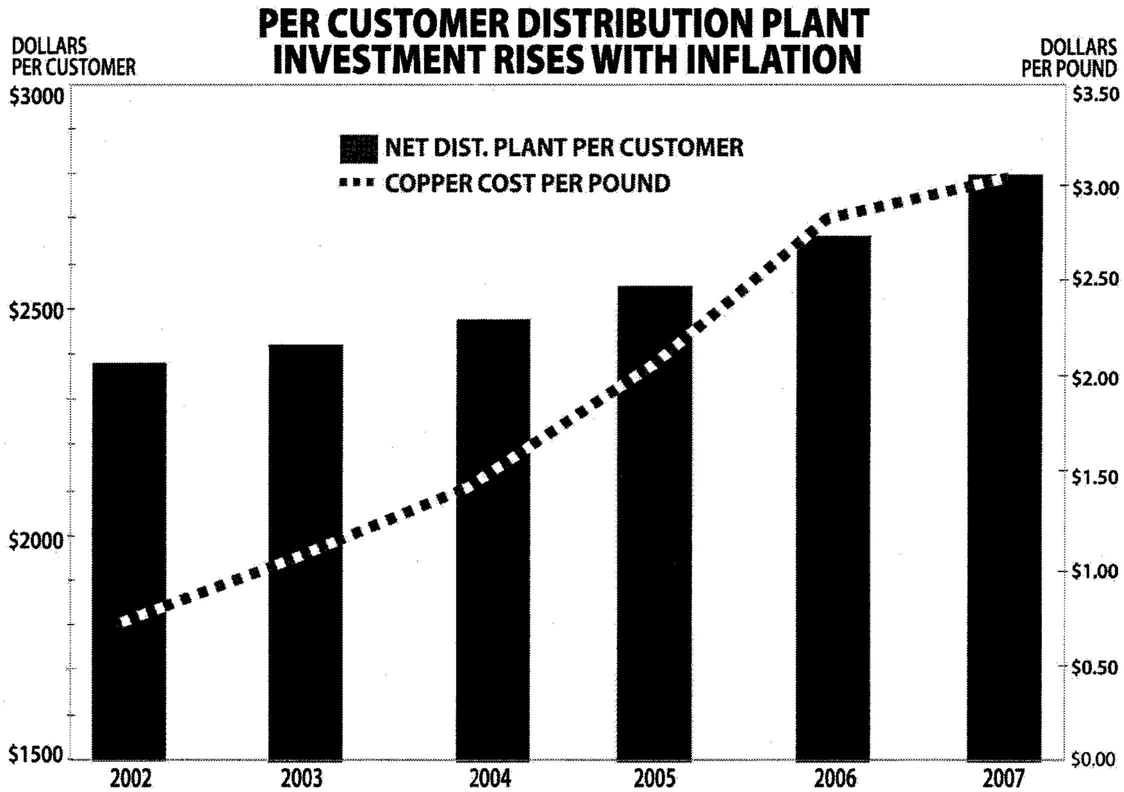


As this table shows, from January 2001 to January 2008, the price of copper rose from 81 cents per pound to $3.02 per pound—an increase of 273%. As of April 1, 2008, the price of copper had further increased to $3.86 per pound—up 84 cents per pound in just four months, bringing the total increase since 2001 to 377%. As of January 2008, the price of aluminum had increased 51% from its 2001 price, rising from 71 cents per pound to $1.07 per pound as of January 2008. And aluminum prices, too, have risen since just the beginning of this year, increasing by another 26 cents to $1.33 per pound as of April 1, 2008. Both commodities are significant components of distribution infrastructure costs.

The effect of these price increases on APS's construction costs (and thus its capital requirements) is striking. For example, two pieces of equipment that are basic to virtually all electrical construction projects are steel poles and transformers. Steel poles are used, among other things, to erect power lines and support other electric supply infrastructure. A transformer is an electrical device that changes electric energy from one voltage to another, thus enabling electricity to be transferred over transmission and distribution wires at different voltages prior to ultimate distribution to the consumer. (For example, a transformer sitting on top of a neighborhood distribution pole might transform a typical distribution voltage of 7200 volts into the much lower 110 to 120 volts used in residences or businesses).

The spike in commodities costs described above has had an extraordinary impact on the costs the Company is forced to incur for each of these two basic pieces of equipment. A 45-foot steel pole, for example, that cost $440 in 2000 now costs the Company $787—a 78% increase in price caused by inflation alone. A 500/230 kVA 3-phase transformer that would have cost APS $2.7 million in 2004 now costs APS $5.1 million—almost twice the price. A 50 kV distribution transformer now costs $1,626 compared to the $953 cost that APS would have paid in 2003—an increase of 70% in just five years. And these are just three examples of many.

There is thus a close correlation between the rise in APS's construction costs and the inflating cost of the materials and commodities used in that construction. The following graph depicts this correlation well, focusing exclusively on the Company's rising per customer distribution costs.



As this graph illustrates, APS's per customer cost for distribution plant (after accounting for the impact of accumulated depreciation) generally tracks the inflation in the Company's key commodities costs, copper being a particularly striking example of the correlation. The Company's per customer distribution costs have risen from under $2,400 per customer in 2002, to more than $2,500 in the year 2005, to almost $2,800 per customer in 2007—an increase of approximately $400 for each of the Company's 1.1 million customers compared to what those costs were just five years ago. And this does not account for the per-customer cost increases required by the Company's growing transmission and generation projects, which have also grown substantially. So not only is APS required to build proportionately more infrastructure than it has in the past, the cost of that infrastructure is higher than it has been in recent memory and continues to rise.

Even with interim rate relief, APS will need to borrow literally hundreds of millions of dollars to construct these ever more costly facilities over the next several years. Access to debt on terms reasonable for APS customers is critical. But, unless the Commission grants this Motion, APS believes there is a very serious risk that its credit will be downgraded to "junk" before the Commission can finally resolve the Company's pending general rate case. As noted earlier, this would cost APS customers as much as a billion dollars of additional interest and severely constrain APS's flexibility to even acquire funds and transact business effectively to serve its over 1 million customers.

APS's parent, PNW, invested some $460 million of additional equity into APS during 2005 and 2006. It has a request pending before this Commission for another potential $400 million equity infusion later this year. Although it is clearly difficult to explain to equity investors why they should continue to pour hundreds of millions of dollars into an enterprise with little prospect of receiving a competitive market return, in fact, these infusions of massive amounts of equity have kept APS's critical funds from operations to debt ratio ("FFO/Debt") above the junk bond level up to now and will continue to do so through the balance of 2008. But, by the time the Commission can issue any decision on the Company's permanent rate application, FFO/Debt will be back in the junk range, and the ability to further prop it up with shareholder funds in the form of yet additional equity infusions from PNW will be essentially exhausted.

And, should resolution of the rate case be delayed by any significant amount of time, APS will be more than teetering on the precipice of junk with no safety margin for even the slightest bit of unanticipated bad news from the capital markets. Although the Commission has acted in a positive manner in the past when confronted with similar circumstances, ratings agencies may grow wary of such last minute interventions and downgrade APS even before a final ruling is made on the permanent rate case unless there is some tangible evidence that things will improve.

On the other hand, a grant of the Company's request for interim rates would clearly represent such tangible evidence and provide a modest level of cushion against a ratings downgrade until the Commission acts on the pending application for permanent rate relief. For example, FFO/Debt will stabilize at 19.6% in 2009 if the requested interim rates are granted. These events would likely be seen and recognized by the financial market as the direct result of a very positive and constructive action by this Commission—one that clearly recognizes the need to get APS back on track and financially prepared for the future.

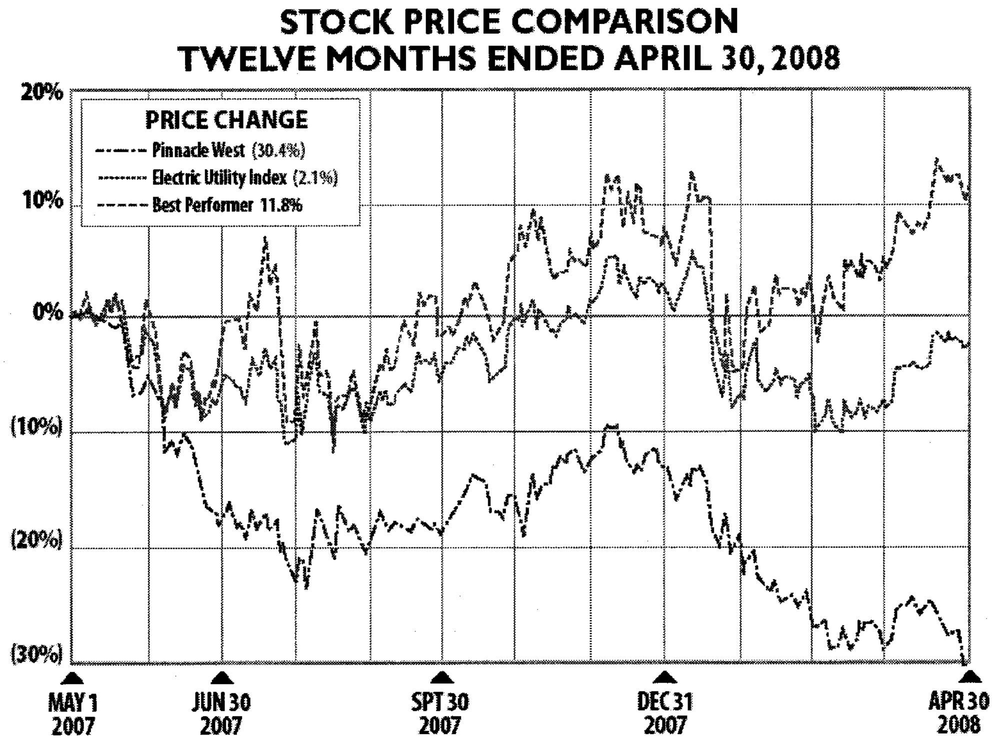
The massive and growing underearnings by APS and the increasingly chronic inability to earn a reasonable return as well as corresponding results of inadequate internal cash flow and falling credit metrics, even immediately after having received rate relief in mid-2007,[4] have not gone unnoticed by the financial markets. As recently as January 31, 2008, S&P expressly commented on APS's weak credit metrics and indicated that the Company's "[r]atings could be lowered to speculative [non-investment] grade if the company is not able to overcome the challenge of ensuring timely recovery of its prudently incurred costs through rate increases approved by the ACC." Standard & Poor's Ratings Direct, "Summary: Arizona Public Service Company," January 31, 2008. Moody's has also expressed this sentiment, explaining that "[g]iven APS's current significant capital expenditure program, the company will require continued, timely regulatory support to maintain credit metrics that are appropriate for its ratings." Moody's Credit Opinion: Arizona Public Service Company, December 17, 2007. Fitch, too, has noted that the Company's "earnings and cash flow attrition due to regulatory lag and/or

[4] Virtually all of the rate increase authorized by Decision No. 69663 went to cover higher fuel costs and resulted in no additional earnings to the Company. Even the Commission's approval of the 2004 Settlement in Decision No. 67744, which resulted in an overall 3.8% base rate increase, resulted in just a .6% increase after again subtracting out base fuel costs and new regulatory mandates, such as higher levels of spending for DSM and additional support for low income programs.

unanticipated disallowances is a significant challenge to the sustainability of PNW and APS's investment grade credit ratings. Revenue increases below our expectations or undue delay would likely result in credit rating downgrades." Fitch Press Release, "Fitch Revises Pinnacle West's Outlook to Negative, Affirms 'BBB-' IDR, December 21, 2007. Brandt Affidavit at ¶27.

These agencies are also aware that APS has eliminated some 300 employee or contractor positions, thus bringing its customer to employee level to 224, compared to less than 200 a decade ago. Budget requests for 2008, both capital and operating, were revised downward. In part, this was due to the slowing economy in Arizona, especially in the housing sector, but it also represented an attempt to further forestall the Company's potential for a further financial downgrade. But no amount of "belt-tightening" can overcome the fundamental problem of having to charge prices that are below costs. To that end, APS first requested of the Commission that already approved Schedule 3 charges be treated as additional revenues, but such request was denied. And, as it was encouraged to do under the current circumstances by Decision No. 69963, APS also filed a new general rate case in March of 2008, which rate case was amended on June 2, 2008. The instant APS Motion represents the best and likely last opportunity to address the ever increasing distress faced by APS prior to the latter part of 2009.

In addition to the concerns expressed by debt rating agencies, the equity capital market's failure to detect any evidence of tangible improvement in the Company's flagging financial condition has led to a significant decline in stock prices, both in absolute terms and compared to the industry. In fact, of all the 26 utilities making up the S&P Electric Utilities Index, PNW stock performance for the 12 months ending April 30, 2008 was dead last, with a loss of value of over 30% or $ 1.4 billion.



Additionally, PNW was the worst performing electric utility stock in the S&P Electric Utilities Index for the three-year period ending April 30, 2008. This sagging stock performance is clearly attributable to the poor earnings of APS and the continued pessimism in the equity market concerning the prospects of any improvement in the near term.

C. Impact of Granting the Requested Interim Relief

Granting the requested Interim Base Rate Surcharge will eliminate less than half the earnings shortfall. However, as also indicated in the attached Affidavit of Mr. Brandt and discussed above, granting the requested interim increase would significantly improve 2008 and 2009 results. Brandt Affidavit at ¶36. It would cover a portion of the costs of owning and operating recently complete facilities that are now utilized in serving APS customers and provide approximately $115 million, pre-tax, of revenues on an annual basis to fund new customer-centered capital projects without the need for incurring additional debt.

The Interim Base Rate Surcharge, if eventually made permanent by a final Commission decision would very significantly reduce the incremental rate impact of that decision on APS customers. This is true irrespective of what that decision determines should be authorized in the way of a base rate increase. And as noted above, granting the Company's Motion will provide APS with a small financial safety margin should that decision be unexpectedly delayed and thus greatly reduces the substantial risk of a downgrade to "junk" status in the absence of interim rate relief.

Granting the APS Motion would also provide a strong conservation message during the upcoming peak usage months and reduce the volatility inherent in rates going down in, say, August of this year, just to go up that much more in 2009. This factor was specifically cited by the Commission in Decision No. 69568 (May 21, 2007) as a rationale for permitting Tucson Electric Power ("TEP") to retain the Fixed CTC component of its rates, which, like the Interim PSA Adjustor, was scheduled to expire. And, as in the TEP order, APS customers would be protected if the final rate order is for less than the Interim Base Rate Surcharge because not only would the then-existing rates be reduced, but customers could receive a full refund, plus interest, of any over-collection.

The protection afforded customers is not reciprocal with regard to APS. If, for example, the Commission determines in its final order that the increase in base rates should be <u>higher</u> than the roughly four mils per kWh represented by the Interim Base Rate Surcharge, APS will have no similar entitlement to retroactive relief. Thus, in no event could APS ever earn so much as a dime more than this Commission determines is just and reasonable.

IV. RELIEF REQUESTED AND LEGAL BASIS

APS requests that the Commission grant the Company an Interim Base Rate Surcharge of approximately $115 million in annual electric revenues through an interim increase in the base rates by $.003987 per kWh. The surcharge should be effective coincident with the roll-off of the Interim PSA Adjustor and would be subject to refund.

The Company has a legal right to full recovery of all prudent costs of providing regulated electric service to the public. In *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (App. 1978), the Court held that "rates established by the Commission should meet the overall operating costs of the utility and produce a reasonable rate of return." *Id.* As such, the Court of Appeals followed the Arizona Supreme Court's earlier holding in *Arizona Corporation Commission v. Arizona Water Co.*, 85 Ariz. 198, 335 P.2d 412 (1959), which stated: "it [the utility] is <u>entitled</u> to a fair return on the fair value of its properties devoted to public use, no more and <u>no less</u>." (Emphasis supplied.) <u>*See*</u> <u>*also*</u> *Wisconsin Public Service Corporation v. Public Service Commission of Wisconsin*, 325 N.W.2d 867 (Wisc. Sup. Ct. 1982) (public service commission's decision to disallow full recovery of prudently-incurred costs to reduce burden of cost recovery on ratepayers lacked rational basis, was arbitrary, and had no basis in sound public policy). Moreover, in setting rates, the Commission has an equal responsibility to protect both customers and shareholders of the utility. *Arizona Community Action Association v. Arizona Corporation Commission*, 123 Ariz. 228, 599 P.2d 184 (1979); <u>*see*</u> <u>*also*</u> *Salt River Valley Canal Co. v. Nelssen*, 10 Ariz. 9, 85 P.117 (1909). Dr. Cicchetti emphasizes in his Affidavit that allowing rates to remain below cost of service is a violation of these basic tenets of utility regulation and a circumstance that warrants prompt regulatory action. Cicchetti Affidavit at ¶23.

When the basic regulatory requirement in Arizona that public service corporations be allowed to recover all prudent costs of providing service and given a reasonable opportunity to earn a reasonable return on the "fair value" of their property cannot be accomplished through the normal ratemaking process or accomplished in a reasonable time given the circumstances, regulatory bodies and, if necessary, the courts must intervene. Specifically, the inability to process a general rate request in a reasonable period of time led the Arizona Supreme Court to permit a utility to establish interim rates. *Arizona Corporation Commission v. Mountain States Telephone & Telegraph Co.*, 71 Ariz. 404, 228 P.2d 749 (1951). Although nowhere using the term "emergency," the Court described that commission's failure to act as a "disregard of their duty, to the Company's financial detriment." It went on to label the Hobson's choice facing Mountain States of either continuing to operate indefinitely with insufficient revenue to recover its costs or suspending operations as "truly appalling." *Id.* at 408.

Based in part on the *Mountain States* decision, the concept of interim rate relief is later discussed in a 1971 Opinion of the Arizona Attorney General, Op. Atty. Gen. 71-17. Op. Atty. Gen. 71-17 was later referenced with approval in *Scates.* In his Opinion, the Attorney General concluded that the Commission had the inherent Constitutional power to impose interim rates with or without the finding of an "emergency." He went on to give a non-exclusive list of examples of circumstances warranting interim rates (*e.g.,* inability to render adequate service without interim relief, inability to act on a request for permanent relief within a reasonable time under the circumstances presented) and of the circumstances (for example, rapidly escalating costs) that could give rise to what the Attorney General termed an "emergency," but nowhere defined or attempted to define the term.

Clearly, however, the concept of an "emergency" must encompass the notion of serious harm to the utility or its customers or both from the failure to take advantage of opportunities to improve the utility's deteriorating financial condition while simultaneously reducing or phasing in future rate increases—both of which circumstances exist here in addition to the rapidly increasing costs that sap the Company's ability to fund needed infrastructure. For example, in a Commission decision involving Arizona Water Company, the prospect of losing current and future income tax benefits, a prospect bad for both the utility and its customers, was found to be a sufficient basis for the grant of interim rates. *See* Decision No. 53349 (December 21, 1982). The impact on TEP finances and the avoidance of a "yo-yo" rate impact on customers, although not termed an "emergency" by the Commission, was found a sufficient basis for the grant of interim relief to TEP previously described. *See* Decision No. 69568. And recently, with regard to APS, the Commission stated: "We agree with Staff that our authority to determine emergencies is not limited to specific, narrowly tailored facts, and that our ratemaking authority is sufficiently broad to enable us to grant relief tailored to many different situations." Decision No. 68685 (May 5, 2006) at 23.

Op. Atty. Gen. 71-17 also discusses important things about the process to be used in granting interim relief. First, no findings of fair value, test period earnings, etc., are required or contemplated. Second, the Commission need not conduct a hearing because consumer interests are fully protected by the refund obligation.

In *Pueblo Del Sol Water Company v. Arizona Corporation Commission*, 160 Ariz. 285, 772 P.2d 1138 (App. 1998), the Court again found that the Commission had the inherent authority to impose interim rates under appropriate circumstances and further found that the Commission need not conclude that an "emergency" exists in order to exercise that authority.[5] For example, in *Pueblo Del Sol*, the inability to conduct a general rate review in a reasonable time was sufficient. This potential for delay in establishing permanent rates was also cited as an appropriate use of interim rates in both *Mountain States* and Op. Atty. Gen. 71-17, with the latter stating that: "the inability of the

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[5] *Pueblo Del Sol* was decided by Division 2 of the Court of Appeals while both *Scates* and a later decision in *Residential Utility Consumer Office v. Arizona Corporation Commission*, 199 Ariz. 588, 20 P.3d 1169 were Division 1 decisions. The *RUCO* court agreed with the result in *Pueblo Del Sol,* but it quibbled with some of the Division 2 court's language. The *RUCO* court did not, however, affect the Commission's discretion to determine when it believes an "emergency" exists, holding only that it must make that determination. To the extent the reasoning used in these decisions is viewed by the Commission as partially inconsistent, APS notes that the circumstances present in this case would easily justify the Commission's finding of an emergency, thus mooting any such inconsistency.

Commission to grant permanent rate relief within a reasonable time would be grounds for granting interim relief."

The inability to finance on reasonable terms and/or to adequately serve customers, as well as delays in the ordinary rate setting process in the face of rapidly escalating costs, are all commonly recognized reasons for granting interim rate relief. As stated earlier, many state jurisdictions grant interim relief. FERC does so routinely, even though it also permits future test periods for rate filings.

In some instances, interim relief (either generally or in specific circumstances such as higher fuel costs) is called for by statute or regulation (*e.g.,* Alaska, Alabama, Arkansas, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Maine, Minnesota, Mississippi, Nevada, New Hampshire, New Jersey, New York, Oregon, Pennsylvania, Texas, Utah and Wisconsin). In other cases, the regulatory agency, like this Commission, was held to have this inherent power. *See Friends of Earth v. Public Service Commission*, 254 N.W.2d 299 (Wisc. Sup. Ct. 1977) (interim rates generally appropriate even without express refund provision); *Grindstone Butte Mutual Canal Co. v. Idaho Power Co.*, 574 P.2d 902 (Idaho Sup. Ct. 1978) (interim rates are within inherent power of commission to authorize); *Toward Utility Rate Normalization v. Public Utilities Commission*, 750 P.2d 787 (Cal. Sup. Ct. 1988) (interim rates permitted upon commercialization of Diablo Canyon nuclear plant even though no final prudence determination had been made.) *See also State of North Carolina Utilities Commission v. Edmisten*, 230 S.E.2d 651 (N.C. Sup.Ct. 1976); and also *City of Grosse Pointe v. Public Service Commission*, 287 N.W.2d 1 (Mich. App. 1979). In both these latter instances, interim rates were found to be appropriate pending a final ruling by the regulatory body on a pending general rate application.

V. CONCLUSION

APS asks the Commission to act swiftly to grant its Motion, even if only on a preliminary basis, prior to the "roll-off" of the Interim PSA Charge. A permanent granting of APS's Motion will increase the funds available to develop needed and service-enhancing infrastructure without additional debt, reduce the threat of further downgrade of the Company's credit rating, make it easier to raise new equity capital by improving earnings, and significantly reduce the impact on APS customers of the final decision in this docket by essentially phasing in any rate increase. And by so acting, the Commission can achieve these objectives with no increase in current customer bills.

* * * *

WHEREFORE, for the foregoing reasons, the Company requests that the Commission:

1. Approve interim rates, subject to refund, in the form of a $.003987 per kWh Interim Base Rate Surcharge with an effective date that is coincident with the "roll-off" of the Interim PSA Charge;

2. Authorize such Interim Base Rate Surcharge to remain in effect until the Commission sets new permanent rates pursuant to the full rate hearing to be held in this docket;

3. Direct the Hearing Division to promptly schedule a Procedural Conference to address the procedure to be followed in the Commission's consideration of the Company's Motion;

4. Grant the Company's Motion on a preliminary basis if the Commission is unable to make a final ruling on the Motion prior to the "roll-off" of the Interim PSA Charge; and,

5. Grant the Company such further relief as the Commission deems appropriate.

RESPECTFULLY SUBMITTED this 6th day of June, 2008.

PINNACLE WEST CAPITAL CORPORATION
Law Department

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Meghan H. Grabel

Attorneys for Arizona Public Service Company

ORIGINAL and 13 copies of the foregoing filed this 6th day of June 2008, with:

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Exhibit A

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

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	DOCKET NO. E-01345A-08-0172 **AFFIDAVIT OF DONALD E. BRANDT IN SUPPORT OF APS'S MOTION FOR APPROVAL OF INTERIM RATE**

General

1. My name is Donald E. Brandt. I am President and Chief Executive Officer of Arizona Public Service Company ("APS" or "Company") and President and Chief Operating Officer of Pinnacle West Capital Corporation ("Pinnacle West"). I am responsible for all aspects of APS operations, including generation, transmission, distribution, customer service, and for general administrative functions. My business address is 400 North 5th Street, Phoenix, Arizona, 85004.

2. The assertions of fact contained within the Company's Motion for Approval of Interim Rate and Preliminary Order (in the form of an interim base rate surcharge of $.003987 per kilowatt-hour ("kWh") to be effective upon the expiration of the $.003987 per kWh 2007 PSA adjustor charge ("2007 PSA Adjustor")) are true and correct to the best of my knowledge and belief.

3. The purpose of this affidavit is to testify, from my personal experience and involvement as the Company's President and Chief Executive Officer, regarding the Company's vision for Arizona's energy future, the financial basis for APS's interim rate relief request, the Company's declining Return on Equity ("ROE") and underearning, Pinnacle West's deteriorating stock performance, the likelihood of adverse actions by the credit rating agencies given the Company's chronically weak financial condition, and the impact on APS and its customers of such actions. I will also discuss the impact of the Company's interim rate proposal on the Company and its customers.

4. As Arizona's largest utility, APS is acutely aware of and firmly committed to its role in shaping Arizona's growing and changing energy future. The Company has a vision of stimulating an energy future for the State that is cleaner, more energy-efficient, more reliable, and more customer-focused than what Arizona has seen historically. For this reason, APS has already begun implementing a series of programs intended to improve customer service and reliability, while setting the stage for technological innovations and other developments that will allow additional customer choice and control over their energy usage.

5. For example, the Company has already achieved one of the highest rates of implementation of full, two-way communication Advanced Metering Infrastructure ("AMI") of any investor-owned utility nationwide, and hopes to have completed its roll-out of AMI for all areas in which such technology is practicable by the end of 2012. In tandem with other "smart grid" improvements to the Company's current capabilities, these meters will allow APS to better serve its customers by offering additional rate choices and, when the technology permits, will provide customers with greater future control over their electricity costs. The Company is also in the process of employing a Distribution Outage Management System – a software program that enables the Company to move from a manual outage management process to a state-of-the-art automated system, setting

the stage for improved outage management as well as a real-time distribution operations system. The Company has also identified and implemented several improvements to its system in tribal territories, which will allow APS to continue its recent trend towards securing higher reliability on Native American lands. In addition, the Company continually strives to upgrade its coal-fired generation plants – beginning with the Cholla Power Plant – such that those plants will meet or exceed all existing and anticipated environmental requirements in the years to come.

6. But all of these benefits require substantial funding – monies in addition to the more traditional expenses that APS must already incur to maintain even its basic electric system in attempt to ensure continued reliability for the Company's current and future customers. These costs cannot be borne – and thus these visionary and important customer-focused programs cannot be funded – by a financially weak utility. Sound long-term financial health for APS ultimately and importantly benefits the Company's customers in the form of comparably lower rates, beneficial customer-focused programs, and sustainable, reliable electric service – fundamental necessities in an age of increasing reliance on and demand for energy.

7. Right now, APS is struggling to maintain even its poor present financial condition. Under the Company's present rates, APS's Funds from Operations to Debt ratio (or "FFO/Debt," a key credit metric, as I later describe) will cross the threshold to non-investment ("junk") grade by the end of next year, quite possibly before the Commission will have issued a decision on APS's general rate application. The Company will thus be left wavering on the brink of junk status with no protection against a credit ratings downgrade during the pendency of the general rate proceedings. As explained at length in my testimony supporting the Company's rate application, a downgrade to junk will have an immediate and acutely adverse effect on the Company and its customers in terms of severely restricted access to financing, dramatically increased financing costs,

and decreased operational flexibility. Once the Company falls from the last rung of the investment grade ladder, to which it now clings, no emergency action from the Commission will be able to reverse those consequences. Instead, it will take years for the Company to regain the financial foothold necessary to climb out of junk and to be financially strong enough to provide Arizona with the basic energy infrastructure that is so vital to our communities, let alone the innovative energy developments that APS envisions undertaking in the years to come. As I will explain herein, I believe that, without interim relief of the type requested in the Company's Motion, it is more than likely that APS will be downgraded to junk status before the Commission issues a decision in the Company's general rate proceeding, resulting in approximately one billion dollars of additional costs over the next ten years that will ultimately be borne by APS customers.

8. If the Commission approves the Company's interim rate request, however, it will improve the Company's financial condition such that APS's FFO/Debt ratio will likely remain in the investment grade range until at least the end of 2009, thus allowing time for the general rate proceedings to resolve and avoiding the threat of a downgrade in the interim. This end cannot be timely achieved through the resolution of the general rate case now on file before the Commission.

9. Significantly, under the Company's proposal, the financial relief resulting from the Company's interim rate request can be achieved with no impact to customer bills compared to what customers are already paying today. In addition, and among other customer advantages that I will describe, the request further benefits customers by reducing by at least 41% the overall bill impact of the Company's general rate request at the time it would be decided and preventing the rate volatility inherent in decreasing customer rates only to increase them again relatively shortly thereafter. The opportunity to provide APS with a much-needed safety cushion against a ratings downgrade during

the pendency of the rate case without increasing customer rates beyond what they are already paying today is one that will be lost if the Commission does not act promptly on the Company's Motion and grant APS the interim relief requested.

Specific Background Facts

10. On March 24, 2008, APS filed a general rate application with this Commission requesting permanent base rate relief, which the Company updated in a revised filing submitted on June 2, 2008 to include a test year ended December 31, 2007 ("Test Year"), as requested by Commission Staff. As updated, the Company's filing requests a permanent net annual revenue increase of $278.2 million, exclusive of the Power Surcharge Adjustor ("PSA") revenues that would simply be reclassified as base revenues under the Company's application.

11. As described at length in that application, APS's general rate request was necessitated by both the extraordinary capital expenditure needs that APS has historically faced and continues to face over the next several years as well as the unfortunate reality that today's rates are significantly below the Company's reasonable costs of operation. This non-discretionary capital spending averages **one billion dollars per year** for the foreseeable future and is caused primarily by the rising costs that the Company must incur to build the infrastructure necessary to meet Arizona's growth and to maintain its existing system – costs that are exacerbated by the unprecedented rise in the price of materials and commodities basic to the electric industry. As the general rate application describes, APS's current rates do not begin to compensate the Company for these costs, which APS must incur to ensure that the Company is able to continue providing reliable electric service to both present and future customers alike. Indeed, from the end of the September 30, 2005 test year used to set the Company's present rates in Decision No. 69663 (June 28, 2007) to May 31, 2008, APS spent approximately $1.7 billion on ACC-jurisdictional

capital projects alone – prudently incurred costs that are not reflected in the Company's retail rates.

12. Pursuant to the Commission's time clock rules, A.A.C. R14-2-103(B)(11), APS requested that the rates approved in its general rate application become effective no later than October 1, 2009. However, given the time the Commission has historically taken to rule on APS rate requests, and understanding the Commission's current staffing shortage and considerable workload, the Company is concerned that the Commission may not issue a decision on APS's general rate case until after that requested date and that any new rates resulting from that order may not take effect before 2010.

13. Because the Company is required (to the extent it is able) to continue high levels of capital spending during this period of regulatory lag with rates that do not compensate it for its cost of service, the Company's financial condition – which is already weak, as I will describe – will continue to deteriorate, and the Company will once again be on the brink of a downgrade to junk credit status as early as next year, before the Commission will likely have ruled on its general rate application.

14. The Company's Motion presents an interim solution to this financial emergency, which the Commission cannot timely rectify through the Company's general rate case application.

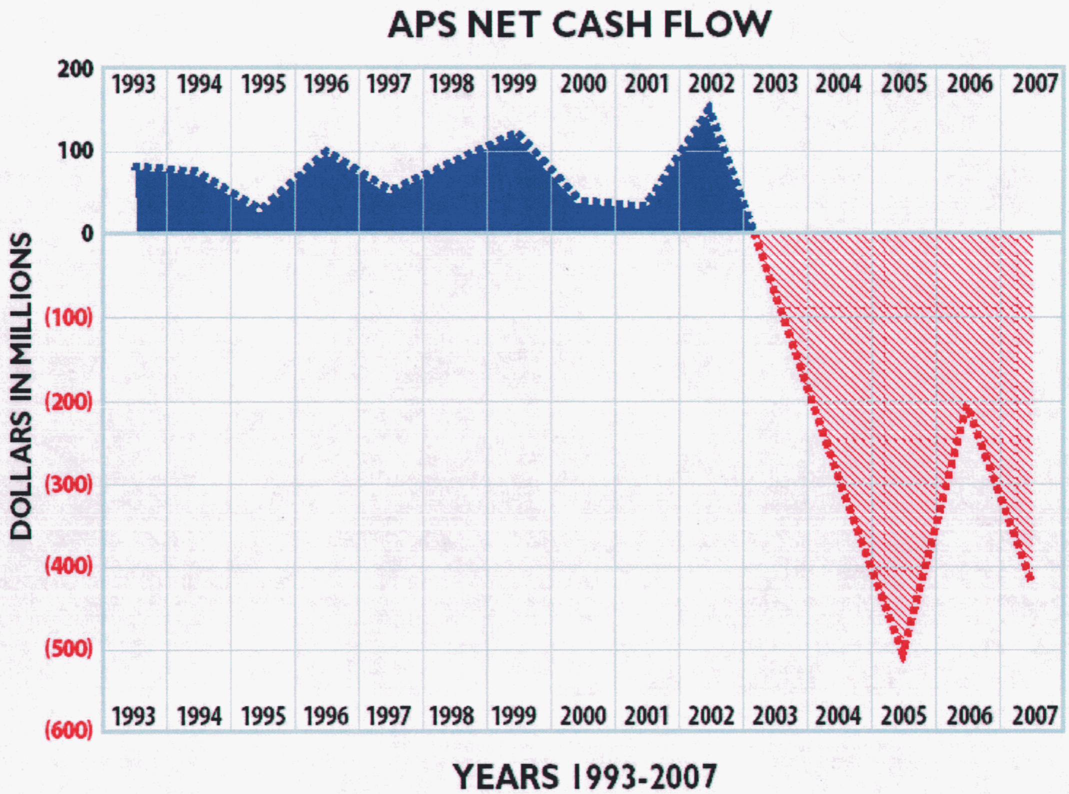
APS's Financial Condition and Credit Ratings

15. The Company's capital expenditure program (consisting of such non-discretionary costs as necessary distribution and transmission lines, generation plant improvements, new environmental control systems, and other service facilities, among other things), together with the Company's need to refinance existing indebtedness as it matures and finance the Company's other capital requirements at the same time, will require the Company to secure over $2 billion of financing from external capital sources over the next five years.

16. The Company's ability to raise these funds depends in large part on its financial vitality – both present and prospective – and the degree to which the financial markets (both debt and equity alike) view APS as an investment-worthy enterprise. However, APS's chronic inability to recover its capital costs has already undermined the Company's financial health and threatens the loss of its financial integrity in the near term without interim relief.

17. APS's financial condition is currently among the weakest of its peers, and continues to decline. In 2007, APS earned an ACC-jurisdictional ROE of only 9.0% (0.4% of which resulted from the impact of unanticipated revenue received during an abnormally hot summer), 175 basis points below its authorized ROE of 10.75%. In 2007 alone, even with unusually hot weather bringing in unexpected additional revenue, the Company's earnings shortfall increased by $67 million, bringing the Total Company earnings shortfall to $321 million over the past five years. Under the Company's present rates, APS's ACC-jurisdictional ROE falls to 8.4% in 2008, to 6.3% in 2009 and to 5.4% in 2010 (just *half* of what APS was authorized to earn in Decision No. 69663). Between the end of the calendar 2007 Test Year and year-end 2010, the Company will have lost another **$384 million** in authorized earnings looking only at those items within the Commission's jurisdiction – a striking level of underearning caused by factors entirely outside of the Company's control.

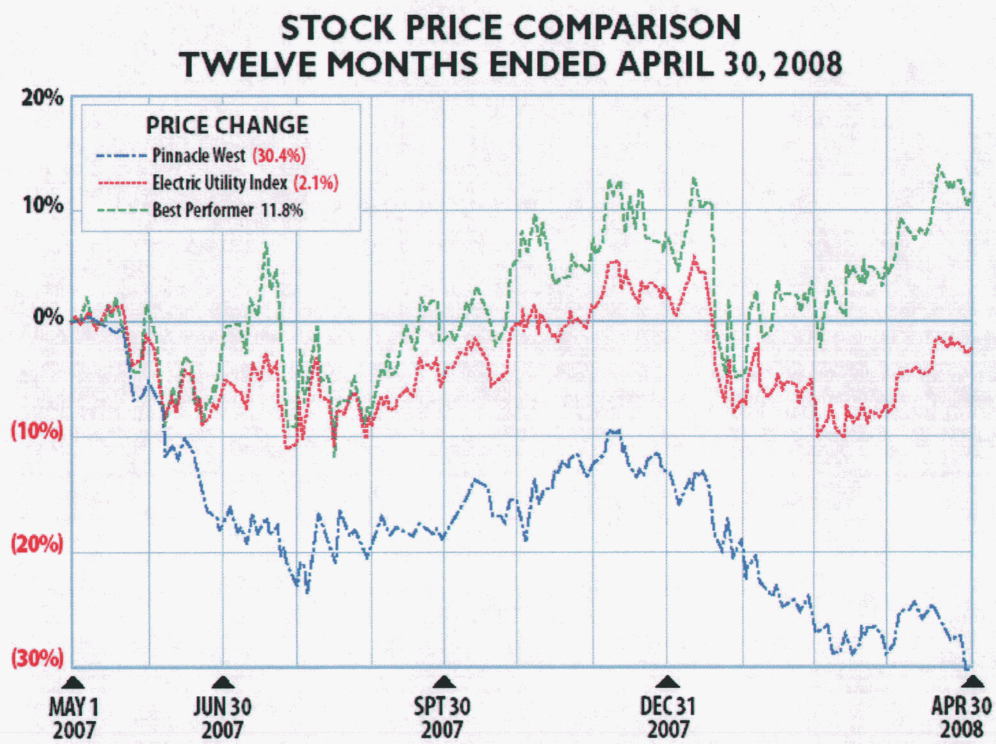
18. Another measure of a company's financial health is to look at its net cash flow, after accounting for capital expenditures and financing costs, by comparing the company's cash receipts to its cash payments over a certain period. By this measure, too, APS's financial vitality has weakened considerably over just the past five years, as the following graph shows.



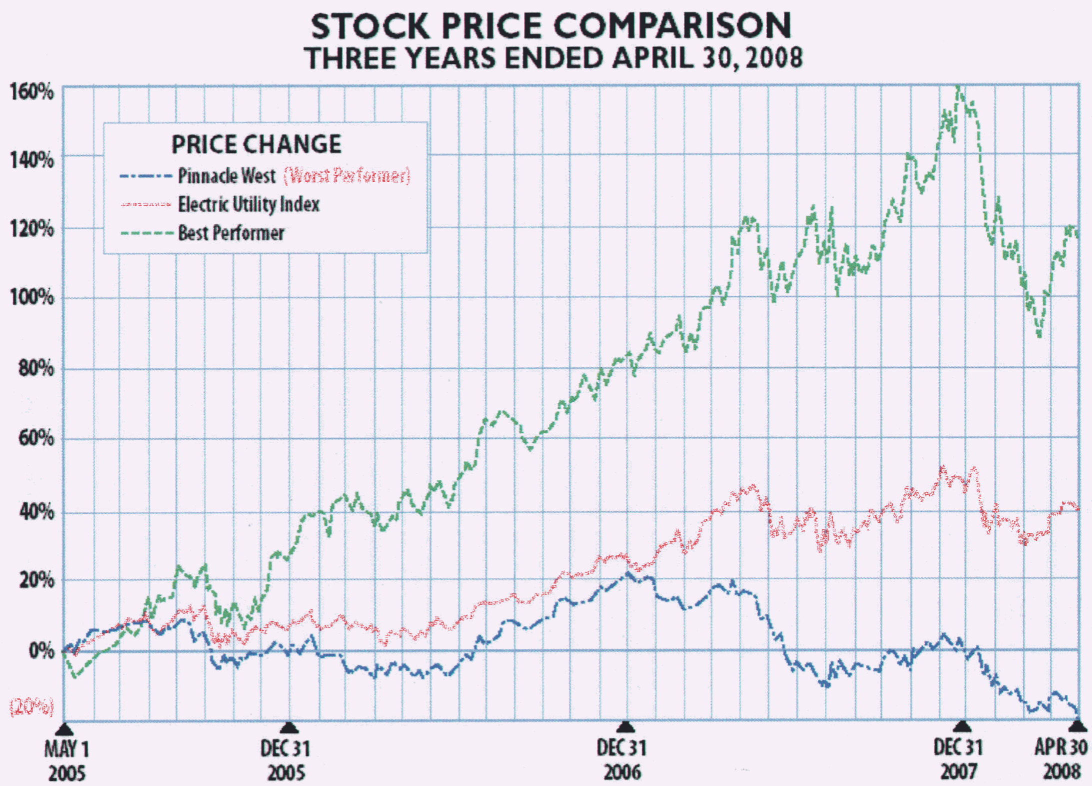
As this graph depicts, from 1993 to 2003, APS was able to limit its cash expenditures to the amount of cash the Company took in, resulting in positive net cash flow and a financially strong utility. One might consider this a "budget surplus" condition, from a state and local government point of view. In 2003, however, that trend reversed, and the Company's required cash outlays began to exceed its cash receipts by significant amounts – a negative cash flow that has resulted in weakening credit metrics and declining financial health. In other words, the Company is now in a "budget deficit" position. Indeed, even with the benefit of the rate increase authorized in Decision No. 69663, APS still experienced a 2007 "budget deficit" of $422 million.

19. APS's subpar financial performance has caused Pinnacle West's stock value to fall considerably, particularly when compared to others in the industry (an industry composed of other investor-owned utilities with which the Company competes for equity

capital investment). As the following shows, of the investor-owned utilities ranked in the S&P electric utility index over the twelve months ended April 30, 2008, Pinnacle West ranked **dead last**, with a loss of stock value of **30.4%**.



20. A longer-term historical look at APS's stock performance does not improve the investment perspective. As the following depicts, Pinnacle West again has the worst performing stock among members of the S&P electric utility index when examining the three years ended April 30, 2008. While the industry averaged a 40.8% increase in value during this period, Pinnacle West's stock value dropped by 19.5% – again placing Pinnacle West dead last.

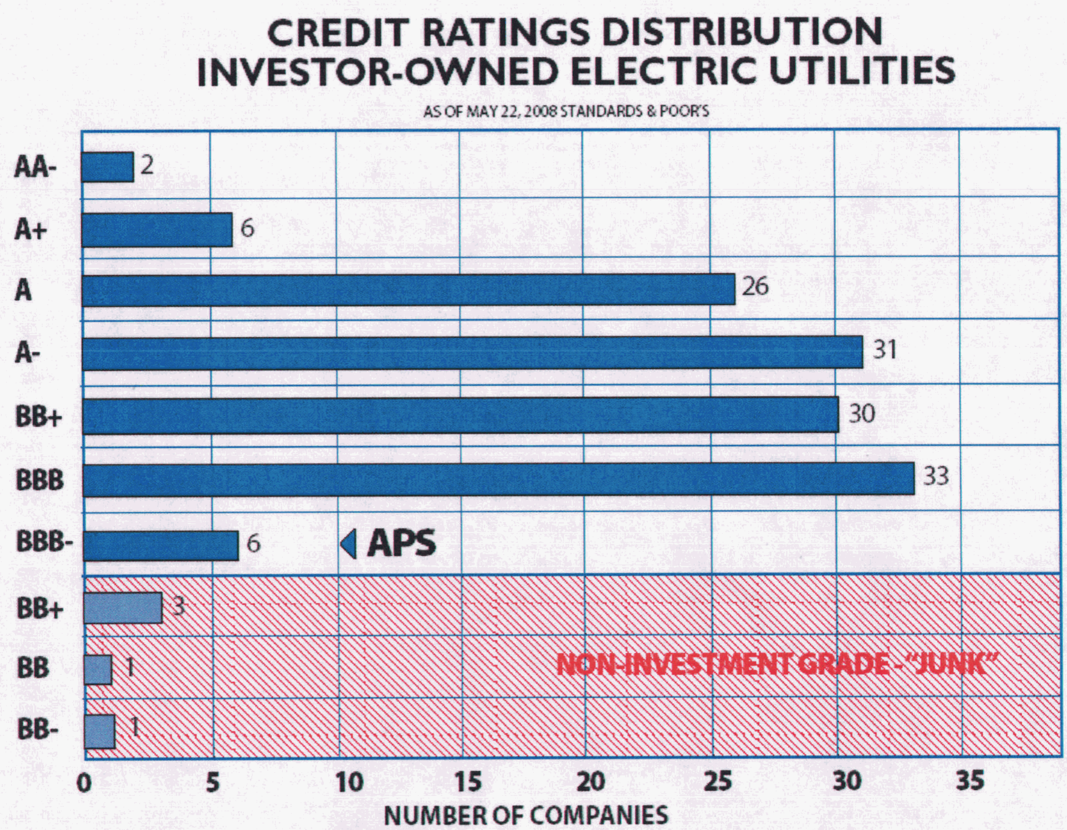


21. This sagging stock performance is easily attributable to APS's chronic inability to earn its authorized ROE and the resulting massive underearnings, as well as apparent pessimism concerning the likelihood of any considerable improvement in the foreseeable future. Investors have little incentive to invest in Pinnacle West with such poor financial returns, especially when their prospect for financial gain is so much better if they invest in the many other better performing utilities nationwide.

22. If the Company is unable to attract sufficient equity investment, APS must either finance its capital expenditure requirements through the debt markets or restrict capital spending by foregoing necessary projects at the risk of jeopardizing service reliability. The second option is hardly a reasonable one from any perspective, and the first – accessing the debt markets and the attendant costs to customers – depends entirely on the Company's credit ratings.

23. The cost that APS must pay for the debt it issues to fund capital expenditures is based on its credit ratings. Every decrease in APS's credit rating increases the cost to the Company – and its customers – of that debt. As described in the Company's general rate application, those costs increase dramatically when a company's credit rating falls to a junk level. For that reason, both APS and its customers have a strong interest in maintaining APS's investment grade credit ratings.

24. APS's credit ratings on its outstanding debt are currently among the lowest that they can possibly be without being regarded as "junk," rated "BBB-" by Standard & Poor's ("S&P"), "BBB" by Fitch Ratings ("Fitch"), and "Baa2" by Moody's Investor's Service ("Moody's). Significantly, APS's credit ratings are among the very worst of the industry. As the following shows, only **five** of the 139 rated investor-owned electric utilities are rated lower than APS.



25. APS thus dangles precariously on the precipice of junk status, and does not have far to fall. And with APS's growing earnings attrition, its financial credit metrics are sliding into junk range. As described in the underlying rate application, credit rating agencies base their credit ratings of companies on certain financial criteria that measure a company's financial health, performance and risk. The rating agencies have established financial metrics as guidelines for determining a credit rating. The key financial metric examined by the credit rating agencies is the FFO/Debt ratio, which measures the sufficiency of a company's cash flow to service both debt interest and debt principal over time.

26. To maintain a BBB credit rating in the Company's present "business profile" category, S&P expects APS to maintain a FFO/Debt ratio of 18% to 28%. But even if Pinnacle West decides and is able to infuse $400 million of equity into APS in 2008 (and Pinnacle West has taken the appropriate first steps with the Commission to do so, as I will discuss below), the Company fully expects that its FFO/Debt ratio will sink below the 18% threshold to junk just next year, falling to 17.6% at the end of 2009 and to 16.6% at the end of 2010 under present rates. These metrics mean that APS faces the real threat of downgrade during the pendency of its general rate case if the Commission does not take action to minimize the negative impact of regulatory lag and provide a much-needed safety cushion against a ratings downgrade in the interim.

27. This fact has not gone overlooked by the rating agencies. As recently as January 31, 2008, S&P expressly commented on APS's weak credit metrics and indicated that the Company's "[r]atings could be lowered to speculative [non-investment] grade if the company is not able to overcome the challenge of ensuring timely recovery of its prudently incurred costs through rate increases approved by the ACC." Standard & Poor's Ratings Direct, "Summary: Arizona Public Service Company," January 31, 2008. Moody's has also expressed this sentiment, explaining that "[g]iven APS's current

significant capital expenditure program, the company will require continued, timely regulatory support to maintain credit metrics that are appropriate for its ratings." Moody's Credit Opinion: Arizona Public Service Company, December 17, 2007. Fitch, too, has noted that the Company's "earnings and cash flow attrition due to regulatory lag and/or unanticipated disallowances is a significant challenge to the sustainability of PNW and APS's investment grade credit ratings. Revenue increases below our expectations or undue delay would likely result in credit rating downgrades." Fitch Press Release, "Fitch Revises Pinnacle West's Outlook to Negative, Affirms 'BBB-' IDR, December 21, 2007.

28. The consequences of a downgrade to junk are dramatic and enduring. APS's current feeble credit ratings – and the very real prospect that those ratings will worsen still – have already caused APS's borrowing costs to increase compared to what they were just a few years ago (before the Company was downgraded by S&P to BBB- in 2005). These increased costs, which result from higher interest rates, will further rise by as much as $70 million to $145 million per year by 2019 if the Company falls just that one step further into non-investment grade – approximately **$1 billion** of additional costs over the next ten years that would ultimately be borne by APS customers.

29. More significantly, and in addition to the other perils that accompany junk credit status described in my testimony supporting the Company's general rate filing, a downgrade might easily cause APS to entirely lose access to the credit markets – particularly in today's volatile credit environment. Indeed, the Company's ability to access the debt markets has already been limited on two separate occasions in 2007 when the credit market was under severe stress. Without access to credit markets and lacking the ability to attract equity investment, APS would have no alternative but to either charge rates sufficient to allow APS to internally finance the Company's billion dollar per year spending obligations or to forego necessary capital projects entirely at a very high risk to service reliability.

Company's Actions to Improve Financial Condition

30. As described in detail in the Company's general rate application, APS has taken a series of actions to improve its financial condition and forestall a downgrade to junk pending permanent rate relief from the Commission. Among other things, APS has initiated the process of eliminating 300 employee or supplemental employee positions – thus further improving its already impressive 224 to 1 ratio of customers per APS employee (a rise in productivity compared to the Company's 198 to 1 customer-to-employee ratio just ten years ago). The Company also underwent a reorganization in late 2007 to enhance the speed and efficacy of decision-making and become more customer-focused, thus additionally improving APS's operational efficiencies. Budget requests for 2008, both capital and operating, were revised downward to help cope with the rising costs of the Company's key materials and components. APS also continues to manage its debt aggressively, saving the Company millions of dollars in financing costs.

31. In yet another internal effort to prevent a downgrade to junk, APS's parent, Pinnacle West, invested $460 million of additional equity into APS during 2005 and 2006 (a sacrifice to shareholders whose investment was thus diluted in the face of already subpar returns), thereby improving the Company's key FFO/Debt ratio to the extent possible during that tense financial time. Pinnacle West currently has another request pending before the Commission for a potential additional $400 million equity infusion into APS later this year. *See* Docket No. E-01345A-08-0228. But even if that request is granted, and even if Pinnacle West is able to issue the massive amounts of equity required to keep APS within investment grade for the balance of 2008, APS's FFO/Debt ratio would subsist within investment range for only a short time – until mid-to-late 2009 – after which time it falls again into junk grade.

32. Thus, by the time in late 2009 or 2010 that the Commission will have rendered any decision on the Company's permanent rate application, the Company's

FFO/Debt will have dropped once again into junk range. Pinnacle West will unlikely be able to infuse equity into APS again prior to that time in order to avert the further deterioration of the Company's credit metrics.

33. Should the Company's ability to charge new rates be delayed at all beyond the requested effective date of October 1, 2009, APS will be left teetering on the verge of junk with no safety margin to guard against the impact of even the slightest unanticipated financial hit. Last minute interventions by the Commission when confronted with such a circumstance may not be enough to prevent a downgrade from the rating agencies even before a decision is rendered on APS's permanent rate application without tangible evidence in the interim that the Company is supported by its regulators and that its financial condition is likely to improve.

Impact of Granting the Requested Interim Relief

34. Granting the Company's request for interim relief would allow continued development of the customer-centered programs described earlier and would clearly provide ratings agencies with critically necessary evidence of on-going regulatory support (evidence that may be enough to prevent a downgrade even in the face of weak credit metrics), and would further provide a modest level of safety margin for the Company until the Commission acts on the pending application for permanent rate relief. Moreover, under the Company's proposal, this important benefit for APS can be realized with no increase to customer bills compared to what customers are already paying today and would offset 41% of the rate increase requested in the Company's permanent rate application.

35. The Company's interim rate proposal works as follows: Decision No. 69663 permitted the Company's 2007 Annual PSA Adjustor of $.003987 per kWh to continue past January 31, 2008, until APS had recovered an additional $46 million of fuel and purchased power costs. APS anticipates that it will have collected this sum and that

the PSA surcharge will thus expire in July or August of 2008. In this Motion, APS proposes that – in order to mitigate the impact of regulatory lag and prevent APS's credit metrics from slipping into junk range before the Commission has the opportunity to rule on its general rate application – the Commission approve an interim base rate surcharge of $.003987 per kWh (roughly "four mils"), to become effective upon the expiration of the $.003987 per kWh 2007 Interim PSA Adjustor. Part of the revenue received from this request will be used to help cover the costs of the approximately $1.7 billion worth of ACC-jurisdictional facilities that have already been built since the end of the Company's last test year and that are already serving APS customers, but which are not recovered under current rates. The Company also proposes that this rate be subject to refund, with interest, at the close of the Company's permanent rate application. Thus, APS customers are protected in the event that the final rate order is for less than this approximately four mil increase in base rates. In that event, not only would permanent rates then be reduced, but customers would receive a full refund, plus interest, of any over-collection.

36. If the Commission approves the Company's interim request, the Company's ACC-jurisdictional ROE rises to 9.4% in 2008 and to 8.3% for 2009. Although these numbers are still significantly less than the 10.75% ROE approved in Decision No. 69663, they are meaningful improvements to the status quo. By granting the requested interim relief, the Commission would reduce the Company's anticipated cumulative earnings shortfall by $100 million between now and year-end 2009.

37. Moreover, the additional revenue generated from the interim rate proposal would suffice to keep APS's FFO/Debt ratio above the 18% threshold and within investment range through the end of 2009, thus mitigating the impact of regulatory lag and giving the Company a moderate cushion of support pending a decision on the permanent rate application. Under APS's interim proposal, FFO/Debt rises by 2% in 2009 to 19.6% as of December 31, 2009. Granting the Company's interim rate request

will thus likely allow APS to circumvent the threat of downgrade to junk during the course of those rate proceedings, assuming the rate case can be resolved and APS is able to charge the resultant permanent rates by early 2010. Granting such interim relief is thus consistent with the Commission's historical recognition that "the benefits of higher bond ratings inure to both the utility and the ratepayer" and therefore that "sound and responsible regulatory action by this Commission is fundamental to the maintenance of desirable bond ratings." Decision No. 51009 (May 29, 1980).

38. The Company's interim rate proposal also works to the benefit of APS's customers. Because APS proposes that the amount of the interim base surcharge should be identical to that of the Interim PSA Adjustor, by timing a large part of the Company's needed non-fuel electric rate increase to coincide on an interim basis with the roll-off of the PSA charge, customers will see no change in their bills if the Commission grants this request above what they are already paying today. Moreover, the interim increase in base revenues, if eventually made permanent in the underlying general rate proceedings, will reduce the incremental impact of the permanent rate request on APS customers by at least 41%. It would, in essence, operate as a phase-in of new rates.

39. In other words, the interim rate proposal provides the Commission with the important opportunity to protect customers from feeling the financial impact of misleading "yo-yo" rates – rates that are temporarily adjusted downward (and further below cost) in July or August only to be kicked back up again by a larger amount at the conclusion of the Company's general rate proceedings. The bill will not go down at the end of this summer, but it will not increase as substantially at the close of the Company's general rate application as it would absent approval of this interim request. Preventing customers from experiencing such rate volatility was specifically cited by the Commission as a reason for allowing Tucson Electric Power to retain a component of its rates that, like

the Company's Interim PSA Adjustor, was scheduled to expire during the course of that utility's general rate proceedings. *See* Decision No. 69568 (May 21, 2007).

40. In addition, the Company's interim proposal has the further benefit of sending appropriate price signals to customers during the time of year when demand on the APS system is at its peak and system costs are at their highest – a result that is not achieved if customers are given a temporary price *decrease* at the exact time of year when customers need to conserve energy the most, only to see those rates significantly increase again later.

41. Perhaps most importantly, customers substantially benefit from the moderate financial improvement to APS's financial health that will result during the general rate proceedings if the Commission grants this application and provides the Company with a cushion of protection against a downgrade to junk status. The proposed $.003987 interim surcharge will result in a one time "phase-in" of $115 million (pre tax) annually against the Company's permanent revenue request (which amount would be refundable with interest at the close of the rate case if the interim relief is greater than the permanent rates allowed). The trade-off of denying that request is the significantly high risk that customers will have to fund over the long-term revenue requirements of hundreds of millions of dollars more if the Company is not able to stave off a downgrade to non-investment credit ratings.

Conclusion

42. APS's current rates do not compensate it for its cost of service. The Company is not able to collect anywhere near the amount of legitimate and prudently incurred costs it has spent and must continue to spend during the course of the permanent rate proceedings to ensure reliable electric service. As a result, notwithstanding proactive efforts from the Company and Pinnacle West, APS's credit metrics will fall into junk credit range during the course of the Company's rate proceedings, before the Commission

is likely to grant the much-needed rate relief. I firmly believe that the Company will more than likely be downgraded to junk during the pendency of the general rate case proceedings without interim relief.

43. The need for interim rates is compelling – the issue is whether and when the Commission grants them. In this regard, the Company's Motion for Approval of Interim Rate and Preliminary Order provides the Commission with the following several opportunities – opportunities that could well be lost if the Commission does not take emergency action: (1) to protect the Company from downgrade during the course of its general rate proceedings by granting an interim rate increase that will not result in an incremental increase to APS customer bills; (2) to fund continued development of projects that will promote efficiency, reliability, sustainability, safety, and customer choice; (3) to shield customers from experiencing a significantly higher rate increase at the close of these proceedings compared to what they would experience absent the interim relief; (4) to send appropriate price signals to customers during peak usage periods; and (5) to protect customers from the impact of rate volatility. Virtually all of these opportunities will be lost if the Commission does not act on the Company's Motion before the termination of the Interim PSA Adjustor in July or August of this year.

This concludes my affidavit.

State of Arizona)
) ss.
County of Maricopa)

I, Donald E. Brandt, having been first duly sworn, state that I have read the foregoing affidavit and that the same is true and correct to the best of my knowledge, information, and belief.

Donald E. Brandt

Subscribed and sworn before me this 6th day of June, 2008.

Linda Redman
Notary Public

My Commission Expires:

Linda G. Redman
NOTARY PUBLIC -- ARIZONA
MARICOPA COUNTY
My Commission Expires
February 8, 2011

Exhibit B

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

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	DOCKET NO. E-01345A-08-0172

AFFIDAVIT OF DR. CHARLES J. CICCHETTI IN SUPPORT OF ARIZONA PUBLIC SERVICE COMPANY'S MOTION FOR INTERIM RATE

Charles J. Cicchetti states under oath and upon personal knowledge and belief:

A. Background and Experience

1. My name is Charles J. Cicchetti, and my business address is Pacific Economics Group, L.L.C., 301 North Lake Avenue, Suite 330, Pasadena, California 91101. I am a co-founding member of Pacific Economics Group, L.L.C.

2. Until recently, I served as the Jeffrey J. Miller Chair in Government, Business and the Economy at the University of Southern California. However, I currently continue to teach economics and public policy part time as an Adjunct Professor at that institution.

3. I actively consult on energy and environmental issues, as well as regulatory and antitrust policies, particularly as those policies relate to regulated industries.

4. I received a B.A. degree in Economics from Colorado College in 1965 and a Ph.D. degree in Economics from Rutgers University in 1969. From 1969 to 1972, I engaged in post-doctoral research at Resources for the Future.

5. I commenced my professional career in 1972 serving as the first economist for the Environmental Defense Fund (EDF), also becoming a faculty member at the University of Wisconsin from 1972 to 1985, earning the title of Professor of Economics and Environmental Studies. I resigned from my association with EDF in 1975 to serve as the Director of the Wisconsin Energy Office and as Special Energy Counselor for the Governor.

6. In 1977, Governor Patrick J. Lucey appointed me to Chair the Public Service Commission of Wisconsin ("PSCW"). I held that position until 1979 and served as Commissioner until 1980.

7. In 1980, I co-founded the Madison Consulting Group, which Marsh and McLennan Company acquired in 1984.

8. In 1984, I was named Senior Vice President of National Economic Research Associates, and held that position until 1987.

9. From 1987 until 1990, I served as Deputy Director of the Energy and Environmental Policy Center at the John F. Kennedy School of Government at Harvard University and directed the Harvard Utility Forum and the Harvard Gas Forum. During

much of this period (from 1988 to 1992), I was also a Managing Director and, ultimately, Co-Chairman of the economic and management consulting firm Putnam, Hayes & Bartlett, Inc.

10. In 1992, I formed Arthur Andersen Economic Consulting, a division of Arthur Andersen LLP. In 1996, I left Arthur Andersen to co-found Pacific Economics Group.

11. In 2002, Governor Gray Davis appointed me as a Republican member of the CAISO's Market Advisory Group.

12. In the course of my career, I have published several books and articles on energy and environmental issues, public utility regulation, natural gas pricing, competition and antitrust. I append a complete list of my publications to this affidavit as Appendix A. Additionally, I have on many occasions given expert testimony in court and administrative proceedings. I also include in Appendix A a list of the proceedings in which I have provided expert testimony since 1980. Much of this testimony concerns the regulation of electricity and natural gas pricing matters in the United States and Canada before state and provincial agencies, the Federal Energy Regulatory Commission, and the National Energy Board, as well as in judicial proceedings.

B. Introduction and Summary

13. I was asked by Arizona Public Service Company ("APS" or "Company") to opine whether, under the present circumstances, APS's request to implement a 4 mil (actually, $.003987, but I will refer to it as 4 mils for the sake of simplicity) per kWh base

rate interim surcharge, to occur coincidentally with the "roll-off" of a power supply adjustment ("PSA") charge of equal amount, would: (1) be considered as being in the public interest; and (2) constitute a reasonable ratemaking approach to the problem of APS's declining financial condition.

14. Based on my experience as outlined above and upon the information both provided by APS and that I obtained independently from public sources, I believe the answer to both of the previous questions is a decided and unequivocal "yes." I reach this conclusion for the following reasons, which I expand upon later in my affidavit and which Donald E. Brandt, President and CEO of the Company, also discusses in his affidavit:

a. APS is suffering a massive and growing earnings shortfall that is eroding its financial strength and making it increasingly difficult to attract debt and equity capital upon terms reasonable to the Company and its customers.

b. This difficulty to attract external debt and equity comes at a time when APS faces immense capital needs both for new infrastructure to serve customers and to refinance existing obligations.

c. If not a financial emergency today, this situation will likely lead to a financial emergency prior to a final order by the Arizona Corporation Commission ("Commission" or "ACC") in this docket and increases the likelihood that even a minor unforeseen negative event will precipitate a financial emergency well before that.

d. The present circumstances are beyond the Company's control and require a prompt and decisive regulatory response such as APS has requested in its Motion for Approval of Interim Rate and Preliminary Order.

e. The ACC can and should positively influence future customer rates and service by creating a situation where APS can first stabilize and then improve its debt ratings and can access additional equity capital through Pinnacle West Capital Corporation ("Pinnacle West") on non-dilutive terms.

f. The benefits to customers of improving APS's financial condition are real, substantial, and long lasting.

g. The scheduled "roll-off" of the PSA charges provides this Commission with an opportunity to address the current situation without increasing customer bills and thus act in a proactive manner, which would help customers mitigate both the effect of a final Commission decision on permanent rate relief and future rate increases that would otherwise be necessary to service more expensive APS debt and equity that would be required to pay for needed infrastructure.

h. Maintaining rates at their present level and off-setting the "roll-off" of the PSA adjustor with an interim base rate surcharge will send better price signals to customers. This would also avoid having rates fall even further below cost and avoid the "yo-yo" effect of first reducing rates just to increase them all the more upon the conclusion of the APS general rate case.

i. If lost, this opportunity will not come back again, and APS customers will face the prospect of a much larger increase in rates next year, which could be substantially mitigated by granting the Company's Motion.

C. Regulatory Perspective

15. As a new reform-minded (some might have said radical, given my prior association with EDF) utility regulator back in the mid-1970s, I came to understand that most of the outside financing necessary to provide safe, reliable, and efficient energy infrastructure came from selling new bonds, or utility debt. I quickly learned that the PSCW could favorably affect the cost of capital for Wisconsin utilities. This was also a time of escalating energy prices and consumer hardships as the nation struggled to recover from the first worldwide oil crisis and the resulting economic conditions. There was also a significant need in my state to build more and better utility infrastructure to continue to provide reliable energy supplies and to help fuel the state's economic recovery.

16. No two historical periods are ever exactly the same. Nevertheless, I am convinced that many of the enormous challenges this Commission faces today are quite similar to what my colleagues in Wisconsin and I confronted in the 1970s. That said, in my tenure at the PSCW, it quickly became apparent that, regardless of all my direct and obvious regulatory decisions, my job as a regulator also entailed keeping and striving to improve the utilities' bond ratings in the state. I soon discovered that even small shifts in fractions of percentages (called basis points, each of which is equal to .01 percent) could

directly and substantially affect the utilities' costs of service or regulated revenue requirements for decades.

17. I learned that the various utility bond ratings would adversely affect financing costs as ratings fell and, further, the amount of debt required would also likely directly increase. As is currently the case with APS, growth could not be fully financed with internal cash flow. However, if we let the gap increase relative to other businesses and were slow to respond to this obvious need, we discovered that the utilities would borrow more money and pay higher annual interest rates to finance the same infrastructure. This would cause consumers to pay more for electricity over the life of the bonds, which are quite typically 30 years.

18. This realization prompted me to conclude that you can best help consumers by being fair to shareholders and being relatively consistent and predictable. The latter meant providing a reasonable opportunity for utilities to earn their authorized rates of return. I specifically learned that when there were unavoidable lags in regulation, we could help consumers pay less over time if we approved "attrition allowances." We also made use of "make whole" adjustments to help customers pay less over time when we discovered utilities were not earning amounts somewhat comparable to their authorized returns due to rates that had become inadequate. I voted to grant relief because I found and believed that the costs associated with these short-term actions paled in comparison to the future rate increases that consumers would pay if bond ratings fell or service levels deteriorated. I also realized that it would be fundamentally wrong to set rates below the

reasonable and prudent cost of providing utility service or to permit such non-compensatory rates to continue any longer than necessary.

19. The current situation with APS is precisely the sort of circumstance where I, as a regulator, would support a means to address deteriorating financial strength with minimal impact on customers. APS has proposed precisely such a remedy in its Motion for Interim Rate.

20. As an academic, and after leaving the PSCW, I studied the details of how utility rating and other financial ratings are established. Analysts calculate various quantitative and qualitative factors. These quantitative ratios mostly compare current and projected cash flow to fixed obligations and the amount of new investments. During my tenure at the PSCW, we generally believed that we could best help consumers if we could keep these performance ratios within a tight range and responded quickly if they slipped from within that range. Fixed obligations (such as interest payments) are not discretionary. This meant that we needed to focus on internal cash flow. This Commission did that, in part, in 2007. However, APS must continue to invest more each year than it can produce internally. Conservative projections show further weakening of net cash flow. As difficult as it might seem in the short run, I believe that this Commission can save consumers a considerable amount of money in the form of lower (future) rate increases if it acts quickly and grants APS the 4 mils per kWh interim surcharge it seeks.

21. I also believed that my job as a regulator meant educating the public that the best regulatory approach was to set a "just and reasonable" return and then to take the steps necessary to assure utilities that performed prudently would very likely earn the returns authorized. Such small regulatory steps would raise rates in the near term, but still only to levels that reflect reasonable and prudent costs of providing service. Moreover, these adjustments would ease the only significant cost state regulators can pro-actively control, the cost of debt that, perhaps with the exception of fuel, is the biggest cost component of an electric utility's cost of service. In the discussion below, with respect and understanding for this Commission and its tough job in facing these daily challenges, I apply my experience and expertise as an outsider looking in on Arizona and APS.

22. APS currently has a greatly weakened financial condition due (and this is an important point) to events *it does not and cannot control.* I review some of these matters below. Most important, as Mr. Brandt has indicated in his Affidavit, APS must spend more than $1 billion in 2008 and approximately $3 billion between 2008 and 2010 on new infrastructure to enable Arizona to grow and to help ensure a reliable electricity supply for consumers. Cash flow from operations falls well short of this necessary investment. This shortfall will increase under what would be, at best, only a temporary PSA rate "roll-off" and would virtually assure that APS remains on the precipice of, and could fall to, "junk bond" status. In my opinion, the prudent regulatory response to the current situation is to replace the PSA with an equivalent base rate surcharge. In effect,

this decision would constitute a regulatory down payment on a system that will keep Arizona competitive and help APS customers to avoid paying even more for energy in the years ahead.

D. Why APS Has a Deteriorating Financial Condition that, if Left Unchecked, will Inevitably Lead to Higher Costs to Customers and, Sooner or Later, a Financial Emergency

23. At a minimum, cost-of-service regulation should provide a meaningful opportunity but not a "guarantee" under all circumstances for investors to earn the authorized return on equity ("ROE") that regulators approve in periodic rate cases. The various state utility commissions can and do differ with respect to how they apply these fundamental cost-of-service standards to particular utilities. In addition, the inadequacy of rates to recover costs under any circumstances calls for regulatory action and is an often-stubborn fact that different regulators must confront and address in a prudent manner. I apply these concepts to APS and find real financial challenges that will increase when the PSA expires, unless the Commission grants a surcharge.

24. With respect, I recommend that the Commission should grant APS's request, in effect, to offset the projected 4 mils per kWh PSA rate "roll-off" with a base rate surcharge of equal amount. APS and its customers confront very real challenges. In my opinion, these real problems negate the transient and relatively small customer benefit of a temporary drop in 2008 electricity rates.

a. APS must invest about $1 billion per year for at least the next five years in order to continue to connect new customers and provide and maintain safe, affordable, and reliable electricity, and to fuel the Arizona economy.

b. Internal operating cash flow and utility earnings are woefully insufficient to support such capital requirements. The "roll-off" of the PSA adjustor would widen the growing gap between APS's new investments and its operating cash flow.

c. Despite receiving much needed rate relief for fuel and purchased power costs in 2007, APS's actual earnings in 2007 are clearly inadequate under any circumstance, and particularly so given the new and replacement debt and equity that the Company must raise. These earnings are well below the amount authorized (10.75% ROE). Indeed, the recent rate relief was mostly focused on fuel and purchased power cost recovery, which flow through to retail customers but do not increase actual APS earnings. This is a crucial fact because, while the 2007 rate relief stopped APS's considerable bleeding of cash used to secure fuel and energy, it did not relieve APS' inherent problems related to earnings erosion and unrecovered capital costs. Indeed, from the very outset, APS has not earned its authorized rate of return under this recent rate case, and as is discussed at length in the Affidavit of Donald E. Brandt, the earnings shortfall is both massive and growing. Allowing the PSA adjustor to "roll-off" without an offsetting base rate surcharge would further weaken APS and cause it to secure new financing with considerably higher costs of capital.

d. APS's debt ratings are very poor, particularly for a utility that needs to invest more than one billion dollars per year. Specifically, the ratings are: (i) Moody's rates APS as Baa2 and its analysts view the company's outlook as "negative"; (ii) Standard & Poor's rates APS as BBB- and its analysts view the company's outlook as stable; (iii) Pinnacle West's debt ratings are a notch lower and are already "junk" grade. The danger for APS's retail customers is that a similar one notch downgrade for APS would, dependent on market conditions, add about 100 basis points to the interest needed to refinance retiring debt and to finance new infrastructure. This would require APS's customers to pay likely hundreds of millions of dollars more in the future for the same infrastructure, assuming that APS could even finance these with "junk" debt. Perhaps more importantly, at "junk" status, APS would experience the serious operational difficulties (collateral calls, loss of vendor credit, etc.) that Mr. Brandt discussed. APS would likely be shut out of the capital markets entirely during certain periods of tight credit.

e. The growth in debt expected and weak cash flow could potentially threaten bond covenants. APS would also need to generate internal equity or receive repeated infusions of equity from Pinnacle West. This will complicate financing for APS's growth without interim relief in the form of a PSA offsetting surcharge.

This would mean raising new equity capital would be more difficult and expensive, if possible at all. And, if the gap between cash flow and new investment expands, the new debt investment would likely come with higher interest rates even if credit ratings do not deteriorate.

E. Why Customers are also Facing What I Believe to be an Emergency

25. These problems and the current conditions present a <u>customer</u> emergency. Utility investors and lenders are mostly willing to match rewards and risk – an equilibrium which causes an increase in interest-related expenses when risks increase. If a state squeezes equity and regularly accepts outcomes where actual earnings fall well short of authorized amounts, utility investors are rather agnostic about taking their returns in the form of higher interest rates for downgraded debt. But the customer pays more regardless.

26. When such regulatory outcomes accompany exceptional growth, utility customers pay much more for a very long time. These higher customer costs are the result of APS's financing requirements and the amount APS must pay outside lenders both to: (a) operate the utility when current cash flow from operations is inadequate; and (b) finance the necessary utility growth with inflated interest rates relative to less risky debt. These are simply the facts and do not represent utility failures.

27. Consider APS's proposal to offset the 4 mils per kWh PSA adjustor "roll-off" later this year with an interim base rate surcharge. The intent is clear and plausible because APS seeks to avoid further earnings erosion in order to mitigate the current and

ongoing deterioration of its finances. APS makes this proposal even as the Commission is about to consider evidence in a new rate proceeding scheduled to be completed sometime in the latter half of 2009. This proposal is necessary and clearly reasonable because APS needs to continue to invest and sell debt in the remainder of 2008 and through 2009, which is the period of regulatory lag that can only be addressed through some manner of interim rate relief.

28. If the APS Motion is granted by the Commission, I conclude retail customers will actually pay less in the future regardless of the final decision in this docket concerning the establishment of permanent base rates. At best, a 4 mils per kWh rate reduction would reduce prices later this year. This would be temporary because APS is seriously under-earning and also investing in needed infrastructure that it cannot finance with internally generated cash flow. A utility company that fails to earn its authorized ROE and that nevertheless must still invest in new infrastructure will become progressively financially weaker. A retail rate reduction would certainly increase negative financial pressure. This would exacerbate the utility's weak credit ratings and further negatively influence analysts' opinions of APS.

29. The costs of debt and other sources of finance will increase. Consumers will pay higher future prices. Mr. Brandt has indicated in his Affidavit that the cost of a further downgrade of APS is more than $1 billion over just the next 10 years, which convinces me that APS's customers would be better off in terms of revenue requirements

savings if this Commission takes the long view and offsets the planned short-term PSA rate reduction with a base rate surcharge of equal amount.

30. I hasten to add that more must still be done in the new permanent rate case to ensure that improvement continues. My primary concern, and I think it should also be this Commission's primary concern, is the need to act aggressively to forestall losing current debt ratings as earnings erode further and cash outlays continue to mount as APS continues to finance growth and the ongoing cost of operations increases. In such dire and challenging circumstances, offsetting a temporary rate cut of less than $50 a year for customers using about 1,000 KWH per month with the requested interim relief seems fully justified, particularly when the beneficial effects on customers becomes a primary focus of regulation.

31. Much is at stake. Financial weakness for APS means APS customers will pay more for electricity. The state's economic growth and job creation will also suffer if prospective investors and new businesses learn or even suspect that Arizona is delaying paying for utility expansion. This could take two forms. First, a utility might sacrifice reliability and maintenance, letting trained employees leave and deferring necessary expenditures. This is <u>not</u> the course APS has taken, as is indicated in the Affidavit of Donald E. Brandt. If anything, there is evidence that APS is doing more with less. This means APS is working harder and smarter – but these efforts alone can never solve a regulatory problem, which is precisely what inadequate rates are.

32. A second aspect of delayed payments in the form of permanent rate relief is that it costs consumers more money in the long run if regulation, in effect, denies or softens the message of higher costs using price signals that are not predicated on the simple, conservative economic and common sense notions that growth increases costs, causes more debt, and increases the cost of fuel and purchase power. Simply selling more at unrealistic current prices does not relieve the crisis or reduce consumer costs over time.

33. Delayed utility payments are like a credit card economy. Consumers get goods and services in the near term. However, they pay more over time. Left unchecked and as consumer credit ratings fall, consumers would and do pay even more to finance the delayed payment of their purchases. Well-regulated utilities like APS hardly ever will over-spend when it comes to basics like fuel, purchase power, iron, steel, cement, meters, etc. However, they can spend more over time in credit card-like higher finance costs and, therefore, cause their customers to also spend more. Regulators should, in my opinion, recognize these realities and act in the customers' interest and on their behalf to avoid these needless additional costs.

F. Conclusion: How to Help Consumers, the State, and to Recognize Shareholders are Making Growth Possible

34. The Commission should recognize that APS has much to do to insure Arizona's continued growth and to provide safe and reliable electricity to its customers.

While APS' need to invest and spend money is great, it lacks and has lacked sufficient internal cash to fulfill its obligations.

35. I ask this Commission to consider how it could help Arizona's utility consumers to pay less over the long haul. Seldom do regulators get to address "needs" of this type or dimension without raising rates. But this Commission has such an opportunity. The Commission can continue to add to the gains made in the last rate case for fuel and purchase power without raising customer bills. Thus, the Commission could best help consumers in Arizona in the long run by granting APS's Motion, and I urge them strongly to do so.

This concludes my affidavit.

State of California)
) ss
County of Los Angeles)

I, Charles J. Cicchetti, having been duly sworn, state that I have read the foregoing affidavit and that the same is true and correct to the best of my knowledge, information, and belief.

Charles J. Cicchetti

Subscribed and sworn to me this 4th day of June, 2008.

DANIELLE NEVEU
COMM. #1710027
NOTARY PUBLIC - CALIFORNIA
LOS ANGELES COUNTY
My Comm. Expires Dec. 10, 2010

Notary Public

My Commission Expires:

Dec. 10, 2010

APPENDIX A

C.V. for Charles J. Cicchetti, Ph.D.

PROFESSIONAL EXPERIENCE

1996-present	Co-Founder, Pacific Economics Group, Pasadena, Ca and Madison, WI.
2006-present	Adjunct Professor, University of Southern California
1998-2006	Jeffrey J. Miller Professor in Government, Business, and the Economy, University of Southern California;
1990-1997	Adjunct Professor of Economics, University of Southern California;
1992-1996	Managing Director, Arthur Andersen Economic Consulting;
1991-1992	Co-Chairman, Putnam, Hayes & Bartlett, Inc.;
1988-1991	Managing Director, Putnam, Hayes & Bartlett, Inc.;
1987-1990	Deputy Director, Energy and Environmental Policy Center, John F. Kennedy School of Government, Harvard University;
1984-1987	Senior Vice President, National Economic Research Associates;
1980-1984	Co-Founder and Partner, Madison Consulting Group;
1979-1986	Professor of Economics and Environmental Studies, University of Wisconsin-Madison;
1977-1979	Chairman, Public Service Commission of Wisconsin, Appointed by Governor Patrick J. Lucey (member until 1980);
1975-1976	Director, Wisconsin Energy Office and Special Energy Counselor for Governor Patrick J. Lucey, State of Wisconsin;
1974-1979	Associate Professor, Economics and Environmental Studies, University of Wisconsin-Madison;
1972-1974	Visiting Associate Professor, Economics and Environmental Studies, University of Wisconsin-Madison;
1972	Associate Lecturer, School of Natural Resources of the University of Michigan;
1969-1972	Resources for the Future, Washington, D.C.;
1969	Ph.D., Economics, Rutgers University;
1968-1969	Instructor, Rutgers University;
1965	B.A., Economics, Colorado College;
1961-1964	Attended United States Air Force Academy.

EDITORIAL AND ADVISORY BOARDS

Journal of Environmental Economics and Management, Former Member
Energy Systems and Policy, Former Member;

Land Economics, Former Editor.
Faculty Advisor to Campus Republicans at USC, 2002 to 2005
Alliance for Energy Security; Former Member;
Association of Environmental and Resource Economics, Former Executive Committee, Former Member;
California ISO Market Advisory Group –Former Member appointed by Governor Gray Davis;
Center for Public Policy Advisory Committee, Former Member;
Department of Energy, Fuel Oil Marketing Advisory Committee, Former Member;
Graduate School of Public Policy at the University of California, Berkeley; Former Board Member;
Institute for the Study of Regulation;
National Association of Regulatory Utility Commissioners, Executive Committee and Chairman of the Ad Hoc Committee on the National Energy Act, Former Member;
Public Interest Economics Center, Board of Directors, Former Member;
Rutgers University, Energy Research Advisory Board;
U.S. Chamber of Commerce Energy and Natural Resources Committee, Former Member.

PUBLICATIONS

Books and Monographs

Working Manuscript entitled "A Primer for Energy Efficiency" Going Green and Getting Regulation Right", January 2008.

Working Paper entitled "Natural Gas: the Other California Energy Crisis" with Colin M. Long, November 2006.

The California Electricity Crisis: What, Why, and What's Next, with Jeffrey A. Dubin and Colin M. Long, July 2004

A Tarnished Golden State: Why California Needs a Public/Private Partnership for its Electricity Supply System, with Colin M. Long, August 2003.

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Exhibit C

APPLICATION

The Interim Base Rate Surcharge ("IR-1") shall apply to all retail electric rate schedules in accordance with their terms with the exception of Solar-2, SP-1, E-3, E-4, E-36 and Direct Access service. All provisions of the customer's current applicable rate schedule will apply in addition to this charge.

RATES

The charges shall be calculated at the following rates:

Interim Rate Charge

All kWh	$0.003987	per kWh