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BEFORE THE ARIZONA CORPORATION COMMISSION

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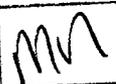
MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE FOR A
HEARING TO DETERMINE THE FAIR
VALUE OF THE UTILITY PROPERTY OF
THE COMPANY FOR RULEMAKING
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

Arizona Corporation Commission
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**INITIAL POST-HEARING BRIEF
OF COMMISSION STAFF (INTERIM RATES)**

October 3, 2008

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1 **I. INTRODUCTION.**

2 This case involves Arizona Public Service Company's ("APS") second request for emergency
3 or interim rates within the last three years. The Company's last request came in 2006, when it
4 requested \$232 million in emergency rates. APS also had a general rate case pending at that time, as
5 it does now. The Company's requests for interim rates appear to be becoming more the norm rather
6 than the exception.

7 In this case, the Company asks the Commission to allow it to implement interim rates to
8 collect an additional \$115 million per year before its general rate case is scheduled to conclude in late
9 2009, which coincides with the amount it received from its Power Supply Adjustor (PSA) surcharge
10 which fell-off in July 2008. The PSA surcharge was approved by the Commission in Decision No.
11 69663 to collect a building balance of fuel and purchased power costs.

12 The Company claims that it continues to need this revenue in the interim to counter the effects
13 of regulatory lag including high capital investment costs which are not yet recognized in rates and the
14 poor stock performance of Pinnacle West Capital Corporation ("PNW") and earnings performance of
15 APS. The Company argues that the poor earnings performance of APS and related poor stock
16 performance of PNW is causing its trended FFO/Debt ratio to fall below 18% in 2009 which could
17 result in a downgrade by Standard and Poor's ("S&P") in its credit rating to junk status. This creates
18 an "emergency" in the Company's view, because of the impact of junk ratings upon its debt costs in
19 the future, which are then passed onto ratepayers. In the words of the Company's CEO, Mr. Brandt,
20 "It's a combination of we haven't earned our authorized rate of return, our credit metrics are
21 extremely weak, we have a BBB-minus teetering on going to junk level, and I believe without the
22 interim adjustment we will be downgraded." (Tr. at 201).

23 In warning of an imminent downgrade absent interim rates, the Company places significance
24 upon its private conversations with three S&P analysts. Unfortunately the Commission lacks the
25 opportunity to inquire of these analysts as to any assertions that they may have made to APS
26 regarding the possibility of an imminent downgrade absent interim rate relief. Staff witnesses Ralph
27 Smith's and David Parcell's reviews of published reports by the three major credit rating agencies,
28 S&P, Moody's and Fitch, do not suggest a downgrade to junk if interim rates are not granted. In fact,

1 Staff witness Smith pointed out that these agencies speak through their published reports and that the
2 basis for their current ratings are typically included in those reports.

3 APS' motion for interim relief and its filed testimony in support thereof, did not persuade
4 Staff that an "emergency" as defined under Arizona law does exist. However, Staff does
5 acknowledge that recent events on Wall Street and in the financial community have substantially
6 altered the financial landscape. While it remains to be seen, it is likely, in light of the current
7 financial crisis on Wall Street, that the Company's access to capital may be more restricted and its
8 cost of debt may be higher. However, the impact of this recent event upon the facts in this case
9 cannot be ascertained at this time.

10 It is true as the Commission stated in its Decision in the last APS emergency case, that its
11 "authority to determine emergencies is not limited to specific narrowly tailored facts," and that its
12 ratemaking authority is sufficiently broad to enable it to grant relief tailored to many different
13 situations. Staff does not believe that the Company's motion and testimony in this case demonstrate
14 the existence of an emergency. However, given the gravity of the recent financial crisis, the
15 Commission certainly has the discretion to find that these circumstances create the prospect of an
16 impending emergency such that the granting of some interim relief would appropriate.

17 In the event the Commission determines that there is a need here for interim rates, Staff has
18 offered an alternative recommendation which would provide APS with interim relief in the amount of
19 \$65 million on an annual basis. The amount was based upon the increase in jurisdictional rate base
20 from the end of the 2005 test year in the Company's last case to the end of the 2007 test year in this
21 case.

22 Staff believes that the Commission can order interim rates in this case if the Commission
23 believes that the record demonstrates some special circumstances, provided some finding of fair
24 value is made in the order issued in the interim case. In other words, the Commission should not
25 have to stand back and wait for an actual emergency to occur prior to taking some action. It is only
26 reasonable that the Commission have the ability to avert an impending crisis, as long as it finds some
27 measure of fair value. The Commission's plenary and exclusive Constitutional authority over rates
28 would seem to necessarily encompass the ability to act to prevent an impending emergency from

1 occurring just as much as it encompasses the ability to act to alleviate an emergency that is in the
2 process of occurring or has occurred.

3 **II. BACKGROUND.**

4 APS provides electric service to more than 1 million customers in 11 of Arizona's 15
5 counties. (Ex. S-1 at 5). APS is the largest subsidiary of Pinnacle West Capital Corporation. *Id.*

6 On March 24, 2008, APS filed an application for a base rate increase with the Commission.
7 On June 2, 2008, it filed an amended application with the Commission. Based upon a test year
8 ending December 31, 2007, it seeks increased rates in the amount of \$278.2 million, composed of a
9 \$264.3 million increase in non-fuel base rates and a \$13.9 million net increase in fuel-related base
10 rates.

11 On July 6, 2008, APS filed a Motion for Approval of Interim Rates. In its Motion, APS
12 sought a rate increase in the amount of \$115 million, or approximately 4 mills per kWh, to be
13 effective with the first billing cycle of November 2008, subject to refund. The amount of the increase
14 was directly tied to the fall-off of the PSA adjustor surcharge, which produced a roughly equivalent
15 amount in revenues. Staff and intervenors filed testimony on August 29, 2008. APS filed rebuttal
16 testimony on September 8, 2008. A hearing on APS' request for interim rates was held the week of
17 September 15, 2008.

18 On July 29, 2008, a procedural schedule was established for APS' general rate case. The
19 procedural schedule provides for the filing of Staff and Intervenor direct testimony on December 19,
20 2008; APS rebuttal testimony on February 6, 2009; Staff and Intervenor Surrebuttal testimony on
21 March 6, 2009; and APS rejoinder testimony on March 20, 2009. A hearing on the Company's
22 request for permanent rates is scheduled to begin on April 2, 2009.

23 On August 6, 2008, in Decision No. 70454, the Commission approved a request by APS for
24 its parent, PNW, to infuse equity up to \$400 million into APS. The Commission approved the
25 increase as long as the equity infusion is made on or before December 31, 2009.

26 The Company's last request for an interim emergency rate increase was filed on January 6,
27 2006. In that case, Docket No. E-01345A-06-0009, the Company requested an interim rate increase
28 of \$299 million (subsequently amended to \$232 million) effective April 1, 2006. The Commission

1 found that no “emergency” existed. The Commission in that case modified the PSA as an interim
2 measure to address the significant and growing deferral of fuel and purchased power costs. Decision
3 No. 68685 at 34.

4 Other recent decisions of the Commission involving APS include the following:

5 In Decision No. 69663, (June 28, 2007), based upon a test year ending September 30, 2005,
6 the Commission granted APS a permanent base rate increase of \$322 million. The Commission also
7 approved a prospective PSA since it would significantly improve APS’ cash flow while allowing
8 APS to recover only prudently incurred costs. The Commission also approved an Environmental
9 Improvement Surcharge (EIS). (Tr. at 469). The EIS was authorized to fund construction for
10 environmental projects. *Id.*

11 In Decision No. 68437, (February 2, 2006), the Commission temporarily allowed APS to
12 defer fuel and purchased power costs above \$776 million pending the outcome of its then pending
13 emergency case. It also allowed the adjustor reset to be moved from April 1, 2006 to February 1,
14 2006 allowing over \$112 million of recovery the following 12 months.

15 In Decision No. 67744, (April 7, 2005), APS was granted a \$75.5 million increase through the
16 Commission’s approval of a settlement agreement between the parties. In that same decision, the
17 Commission also approved a PSA for APS for fuel and purchased power costs. It further allowed
18 APS to rate base PWEC assets. In Decision No. 67744, the Commission also authorized a Demand
19 Side Management (DSM) for the Company.

20 In Decision No. 63354, (February 8, 2001), the Commission authorized an Environmental
21 Portfolio Surcharge. That Surcharge was changed to the REST Surcharge when the Commission
22 approved the Company’s REST implementation plan in Decision No. 70313.

23 In Decision No. 67744, (April 7, 2005), the Commission also authorized a Transmission Cost
24 Adjustor (TCA) for APS. In Decision No. 70179 (February 27, 2008) the Commission approved the
25 first implementation of the TCA in response to higher FERC authorized transmission. In Decision
26 No. 70400, (July 3, 2008), the Commission approved the second revision to the TCA to pass through
27 FERC authorized transmission costs.

28

1 In Decision No. 70185 (February 28, 2008), the Commission approved a revision to Tariff
2 Schedule 3 (Line Extensions) to eliminate the free footage allowance.

3 **III. DISCUSSION.**

4 **A. APS' Request For Interim Relief.**

5 APS is seeking an interim rate increase of approximately \$115 million or nearly 4 mills per
6 kWh, to be effective with the first billing cycle of November, 2008. (Ex. S-1 at 5). That amount
7 coincides with the loss of revenue due to a roll-off of the Company's surcharge of \$0.003987 per
8 kWh, approved in Decision No. 69663, to collect a \$46 million balance of uncollected fuel and
9 purchased power costs. *Id.* at 6.

10 The Company cites a number of factors to support its need for interim rate relief, the bulk of
11 which are related to "regulatory lag." It claims that it has invested over \$1.7 billion for new facilities
12 that are not yet reflected in rates. (Ex. APS-1 at 5). It also claims that, it has been unable to earn its
13 authorized rate of return. *Id.* at 7. It also cites to the poor stock performance of its parent, PNW. *Id.*
14 at 8-9. The Company alleges that these problems have exposed it to a high risk of being downgraded
15 by S&P to "junk" status. A downgrade would impact the Company's cost of financing and access to
16 capital markets in the future. *Id.* at 3-4, 13. Each of these factors is summarized briefly below:

17 1. Regulatory Lag and the Historic Test Year: The Company
18 claims investments of around \$1.7 billion since the end of the test
19 year in its last rate case and continues to have a very aggressive
20 construction budget. The Company also claims significant
21 increases in the cost of raw materials. It claims that its inability to
earn on this investment is leading to sagging earnings with respect
to both PNW and APS. Company witness Brandt claims that PNW
stock is underperforming largely because of APS' inability to earn
its authorized rate of return.

22 2. S&P Bond Ratings: Because of the impacts of regulatory
23 lag, the Company claims that there is a 75-100% probability that
24 S&P will downgrade the Company's credit rating from BBB minus
25 to BB plus or non-investment grade levels. In arriving at this
26 conclusion, the Company relies principally upon private
27 conversations it has had with S&P analysts. The Company claims
28 that S&P analysts intend to take the Company's rating back to
"Committee" right after the Commission makes a determination on
the Company's motion for interim rates.

1 **B. The Commission has Broad Discretion Pursuant to its Constitutional Authority**
2 **to Determine Whether An Emergency Exists or Whether Interim Rates are**
3 **Appropriate.**

4 The Commission possesses broad and exclusive authority to determine appropriate rates
5 pursuant to its Constitutional authority. Ariz. Const. Art. XV, § 3; *Arizona Corp. Comm'n v. State ex*
6 *rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (1992); *State v. Tucson Gas, Elec. Light and Power Co.*, 15
7 Ariz. 294, 138 P. 781 (1914). This authority extends to the consideration of emergency and/or
8 special circumstances that may warrant rate relief on an interim basis. Op. Att'y Gen. 71-17 (1971).
9 The issue addressed by the Attorney General ("AG") was "whether the Corporation Commission
10 itself has jurisdiction to establish interim rates under certain conditions if it finds that the corporation
11 is receiving a confiscatory rate of return under its present rate schedules." *Id.* at 2. The AG stated as
12 follows:

13 The foregoing authorities make it clear that, in general, courts and
14 regulatory bodies utilize interim rates as an emergency measure when
15 sudden change brings hardship to a company, when the company is
16 insolvent, or when the condition of the company is such that its ability to
17 maintain service pending a formal rate determination is in serious doubt.

18 *Id.* at 13.

19 In addition, the AG's Opinion contemplated that the Company would post a bond with rates
20 being subject to refund and that there would be an ultimate finding of fair value by the Commission
21 upon which final rates would be based. *Id.* The subject of interim rates prior to a finding of fair
22 value by the Commission has also been the subject of several court cases in Arizona.

23 In *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (App. 1978), the
24 Arizona Court of Appeals followed the Attorney General's Opinion discussed above. It struck down
25 an Order of the Commission approving an approximate \$5 million rate increase without a finding of
26 fair value. The Court's Opinion noted with approval the AG's conclusion that interim rates should be
27 used where an emergency exists, where a bond is posted guaranteeing a refund to the utility's
28 subscribers if any payments are made in excess of the rates eventually determined by the
29 Commission, and where a final determination of just and reasonable rates is to be made by the
30 Commission after it values a utility's property." *Id.*

1 Increases or decreases to rates as a result of automatic adjustment clauses are also permitted.
2 *Scates*, 118 Ariz. at 535, 578 P.2d at 616. “Such clauses usually embody a formula established
3 during a rate hearing to permit adjustment of rate in the future to reflect changes on specific operating
4 costs, such as the wholesale cost of gas or electricity.” *Id.*

5 In *Pueblo Del Sol Water Company v. Arizona Corporation Commission*, 772 P.2d 1138 (App.
6 1989), the Court affirmed a Commission decision wherein it established interim rates based upon
7 existing rates that had already been subject to a fair value finding by the Commission.

8 And, in *Residential Utility Consumer’s Office v Arizona Corporation Commission*, 20 P.3d
9 1169, 1173 (App. 2001) the Arizona Court of Appeals found that something more than an increase to
10 costs is necessary for the Commission to authorize the use of interim rates (“Clearly, *Scates*
11 contemplated, and we agree, that interim rate making requires all three elements-an emergency
12 situation, the posting of a bond, and a subsequent full rate case-in order to comport with the
13 constitutional mandate that rates be just and reasonable.”) Thus, virtually, every court case which has
14 examined this issue requires the presence of an emergency or exigent circumstances that go far
15 beyond the impacts of ordinary regulatory lag.

16 The question then becomes what constitutes an emergency or the type of exigent
17 circumstances that would support the setting of interim rates prior to an evidentiary hearing where the
18 issues of fair value and rate of return can be addressed. The question of what constitutes an
19 “emergency” is largely an issue of fact for the Commission to decide. In the Company’s last
20 emergency case, Docket No. E-01345A-06-0009, Staff summarized the nature of “emergency” relief
21 granted by the Commission in the last ten to fifteen years. Significantly, the summary noted that,

22 Most emergency rate cases before the Commission in the past ten to
23 fifteen years involved small water systems facing a crisis of being unable
24 to provide adequate and reliable service without an immediate increase in
25 rates. Many of the cases involved significant operation and maintenance
26 deficiencies. *See* Decision Nos. 57841 (Mountain View Water Company)
27 and 67990 (Sabrosa Water Company). Others involved water quality and
28 regulatory compliance issues from other state agencies. *See* Decision Nos.
61833 (Far West Water Company) and 62651 (Thim Utility Company,
E&T Division). The Commission, however, has also denied or partially
denied applications for emergency rate relief. *See* Decision Nos. 57668
(E & R Water Company et. al.), 59250 (Mountain View Water Company
and 61930 (Vail Water Company).

1 (Staff's Closing Br. at 3).

2 In the majority of those cases where emergency interim rate relief was approved, the crisis
3 defined by the company had already occurred or was occurring. In its Decision in the Company's last
4 emergency case, the Commission reiterated that its authority to determine emergencies is not limited
5 to specific, narrowly tailored facts, and that the Commission's ratemaking authority is sufficiently
6 broad to enable it to grant relief tailored to many different situations. Decision No. 68685 at 23. The
7 Commission's decision to grant emergency rate relief should be focused upon whether the application
8 alleges circumstances sufficiently urgent to concern the interest of the public. While the AG's
9 Opinion sets out defining criteria that the Commission routinely uses to evaluate an application for
10 interim rates, whether a particular set of facts falls within those criteria is something that the
11 Commission must decide.

12 In addition, Staff believes that the Commission can order interim rates in this case if the
13 Commission believes that based upon the record an emergency is likely to occur, as long as some
14 finding of fair value is made in the order issued in the interim case. In other words, the Commission
15 should not have to step back and wait for an actual emergency to occur prior to taking some action. It
16 is only reasonable that the Commission have some ability to act to avert an impending crisis, as long
17 as it finds some measure of fair value. The plenary and exclusive Constitutional authority of the
18 Commission over rates would seem to necessarily encompass the ability to act to prevent an
19 emergency from occurring just as much as it encompasses the ability to act to alleviate an emergency
20 that is in the process of occurring or has occurred.

21 The Attorney General recognized that "...the Commission's broad and exclusive legislative
22 power to choose the modes by which it establishes rates...should be construed broadly enough to
23 permit the Commission to avail itself of concepts and procedures which are devised from time to time
24 to permit effective utility regulation and to keep pace with constantly changing economic and social
25 concerns." Op. Att'y Gen. 71-17 at 3 (citing Op. Att'y Gen. 71-15 (1971)).

26

27

28

1 C. **APS' Motion and Testimony Do Not Meet the Criteria for an Emergency as Set**
2 **Forth by the AG; at Most Questions Exist as to Whether the Company is Facing**
3 **an Impending or Imminent Crisis.**

4 It is Staff's position that the Company in its motion and testimony has not actually
5 demonstrated the existence of an emergency that would justify the requested relief. Staff
6 acknowledges the impact of recent events on Wall Street which render financial markets, even for
7 utilities, more tenuous at this time. And while no one can predict the outcome of this most serious
8 development at this time, these circumstances combined with the Company's unique situation could
9 create the type of urgency that could be used as the basis for some interim relief in this case. It is
10 Staff's position that Commission action may at most be justified to avert an impending or imminent
11 threat of emergency since a full-fledged emergency does not exist at this time. The testimony
12 adduced at the hearing has been consistent that the Company does not face so complete an inability to
13 continue service at this time as typifies the entities that ordinarily request and receive emergency rate
14 increases.

14 1. **It is impossible to predict at this time what impact the financial market**
15 **crisis will have on APS.**

16 It is impossible to ignore the events that unfolded on Wall Street during the week of the
17 hearing in this matter and their impact in this case. The crisis was discussed to by several witnesses
18 during the course of the proceeding. But, even Mr. Brandt conceded that no one can predict what is
19 going to happen in the financial markets and how long this will last. (Tr. at 385).

20 Mr. Smith's testimony gives a short synopsis of the events of the week in the following
21 passage taken from the transcript in this case:

22 ...over the past few days there's been a substantial amount of turmoil in
23 the market. Merrill Lynch is being acquired by Bank of America, Lehman
24 Brothers is in bankruptcy, and now it looks like AIG is getting a – I don't
25 know if it's like 85 billion, or something in that range, loan from the
26 federal government. It's just a very uncertain time in the market.

27 *Id.* at 623.
28

1 Mr. Smith commented on the potential impact on utilities:

2 ...[t]here's a lot of concern over the subprime mortgage market. I think
3 Mr. Brandt's comments about bank loan availability tightening up are
4 well-taken. I'm not sure how those events in the financial markets would
5 affect the credit rating agencies' criteria for public utilities.

6 I think...public utilities such as APS have their prices set by regulation
7 and...they have different characteristics than a lot of other entities such as
8 banks or other types of corporations that are operating in a competitive
9 environment.

10 *Id.* at 643-44.

11 When asked about the events of the week and how they could affect the Company, Staff
12 witness Parcell stated:

13 I don't know. I mean, by the time the interim rates approval or non-
14 approval comes about, we're either going to be in a better situation, or
15 who knows, even a worse situation. This financial thing didn't start
16 yesterday. It began with the subprime lending about a year ago, and it has
17 just ballooned. I mean, you have heard the expression: When the US
18 sneezes, the world gets a cold. Well, the world has got pneumonia right
19 now. We've all got a cold. This is a serious situation, and it could be
20 better or worse.

21 What does that do to the rating agencies? I mean, you have to believe
22 there's some pressure from the fed and other people saying, don't make
23 things worse, but you'll never see that printed or hear that.

24 *Id.* at 905.

25 Mr. Smith also commented upon the impact of the current financial crisis on Staff's position
26 in the following exchange:

27 Q. I intended to include the uncertainty unfolding from this point
28 forward as a result of the financial events of the last two weeks.
And, so modified as to my question, does it in any way alter your
response?

A. By the events of the past two weeks you are referring to the
Lehman Brothers bankruptcy and the Merrill Lynch takeover, et
cetera?

Q. Fannie Mae, Freddie Mac, AIG, yes and what may be yet to come.

A. It doesn't --- I don't think it alters Staff's conclusion about the
interim rate increase recommendation. It certainly had some
impact on the recommendation that we had originally made to tie
an equity issuance to granting of interim relief, and which we've
withdrawn. So it did have some impact in that respect."

29 *Id.* at 646.

1 As discussed by Staff witness Smith in the passage above, certainly, the growing crisis
2 affected the Staff's position with respect to the Company's ability to issue equity, resulting in Staff
3 changing its position that any interim relief should be contingent upon PNW making the authorized
4 equity infusion into APS. *Id.* at 623-24. Mr. Smith testified that, given the current economic climate
5 and PNW's lower than expected stock performance, the Company should have some flexibility with
6 respect to when it makes an issuance. *Id.* at 623.

7 As to debt, credit markets are now very tight but are expected to relax once again when and if
8 Congress signs off on a multi-billion dollar bail-out plan. With respect to debt authorization and the
9 amount left in the Company's cap, Mr. Brandt testified that the previous cap was \$2.8 billion in long-
10 term debt, and that was increased to \$4.2 billion. *Id.* at 601. So the Company has approximately
11 \$1.4 billion in headroom left. *Id.* For short-term debt, which is constrained by state law unless the
12 Commission decides otherwise, the Company has been authorized to obtain a total of \$900 million.
13 *Id.* The Company did go out and get a bank revolving credit facility in the amount of \$900 million,
14 but has not drawn on it yet. *Id.* The ultimate impact of this crisis upon the Company's ability to
15 obtain debt financing is not known at this time.

16 As discussed below, Staff does not believe that the Company's motion or testimony in this
17 case meets the criteria for an emergency under Arizona law. Staff does acknowledge, however, that
18 the events of the last two weeks in the financial markets raises questions as to whether the Company
19 may face an impending crisis or emergency.

20 **2. APS' motion and testimony taken alone do not meet the criteria for an**
21 **emergency under Arizona Law.**

22 APS' motion and testimony in this case do not meet the criteria for an emergency specified in
23 the Attorney General's Opinion, 71-17. As discussed above, the Attorney General found that "in
24 general, courts and regulatory bodies utilize interim rates as an emergency measure when sudden
25 changes brings hardship to a company, when the company is insolvent, or when the condition of the
26 company is such that its ability to maintain service pending a formal rate determination is in serious
27 doubt." *Id.* at 13.

1 Some conditions that could constitute a financial emergency include an inability to raise
2 capital at reasonable terms, inability to meet required coverage ratios specified in bond indentures, a
3 cash flow crisis, or inability to pay current expenses.” (Ex. S-1 at 9).

4 APS has not defaulted on any bond indenture or credit arrangements. *Id.* at 26. APS is not
5 insolvent, and is not experiencing a financial emergency. *Id.* at 16. The Company does not have a
6 cash flow crisis. (Tr. at 673). APS’ response to Staff Interim 2.76 states that the Company has \$900
7 million in committed credit facilities available to it through 11/2010. (Ex. S-1 at 16)). APS has not
8 indicated that it cannot pay current expenses.

9 APS has not identified any sudden or unanticipated circumstance affecting its ability to offer
10 reliable electric service. (Ex. S-1 at 15; tr. at 141-42, 150).

11 Further, APS has not indicated that without the interim rate increase it will not be able to
12 provide safe and reliable electric service to customers in 2008 and 2009, prior to the conclusion of the
13 permanent case. (Tr. at 141). APS witness Brandt also testified that the Company would do its best
14 to ensure that the quality of service does not suffer. *Id.* at 142.

15 Denial of the interim rate increase will not even affect the Company’s ability to pay
16 dividends. *Id.* at 150. The Company pays common dividends every quarter. *Id.* In 1991, the
17 dividends paid were reduced to \$170 million and have remained at that level through 2007. *Id.* at
18 151. PNW also pays common dividends every quarter. The annual rate is \$2.10 per share after
19 increasing annually for about 13 years until 2006. *Id.* at 458-59.

20 In fact, most parties which have addressed this issue to-date believe that no emergency
21 currently exists. For instance, AECC witness Higgins stated that while, the facts are different in this
22 case, on the issue of whether there is an emergency, he does not see any facts that would cause a
23 different conclusion than the conclusion reached in the last case. *Id.* at 285. RUCO also questioned
24 whether a true emergency exists. *Id.* at 1052-53.

25 APS bases its belief that an emergency exists largely upon the prospects of a downgrade by
26 S&P of its bond rating from investment to non-investment grade. But APS Witness Brandt’s almost
27 exclusive reliance upon the Company’s trended FFO/Debt ratio puts the Commission in a position of
28

1 having to engage in a game of probabilities with respect to the need for interim rates and whether or
2 not an emergency exists.

3 The important thing...do you want to bet a billion dollars on whether we
4 get downgraded or not. That in my mind is a financial emergency. I
5 really don't have to have an Attorney General's opinion to tell me what
6 that situation is. It is a financial emergency. Now if under Arizona law
7 we can't call it an emergency, so be it. It is a very serious problem that if
8 it is not addressed has a very high probability of lading a billion dollars
9 of additional cost on our customer that is completely unwarranted.

10 *Id.* at 438-39.

11 To support its position APS also points to Decision No. 53909, which was the Commission's
12 decision on a 1983 request by the Company for an emergency interim rate increase. In that case,
13 however, the Commission found that APS was in the midst of an extensive construction program of
14 the Palo Verde nuclear generating facility. There, the Commission found that there was an imminent
15 risk of the Company going from a BBB+ rating all the way down to a BB non-investment rating. The
16 Commission also noted that the Company's ability to finance construction necessary to honor
17 existing contracts with the co-owners of Palo Verde was in jeopardy. Those types of circumstances
18 are not present in this case.

19 In 2006 the Company raised many of the same arguments it raises today, yet the Commission
20 found that no "emergency" existed. But there were also important differences between this case and
21 the 2006 case. First, back in 2006, S&P had just downgraded the Company from a business profile 5
22 to a profile 6 and from a credit rating of BBB to a BBB minus. At that time, APS' FFO/Debt ratio of
23 approximately 14.8 did not support either a business profile 6 or 5. (Tr. at 449-50.)

24 At the time of the Company's last case, there were also serious concerns regarding the
25 increasing balance of uncollected fuel costs and several outages at the Palo Verde nuclear facility as
26 well as a Nuclear Regulatory Commission ("NRC") investigation. *Id.* at 506. Rather than finding
27 that an "emergency" existed, the Commission modified the Company's PSA adjustor mechanism to
28 allow for collection of the growing balance of uncollected fuel costs. The Company in this case
admitted that its circumstances back in 2006 were more tenuous. *Id.* at 51. And even witness Brandt
acknowledged in this case that the PSA avoided a potential insolvency.

1 In summary, the Company does not meet the criteria for an “emergency” set forth in the
2 Attorney General’s Opinion discussed above. At most, Commission action may be necessary to
3 prevent an impending crisis when one considers the uncertainty associated with the financial market
4 meltdown of the last two weeks.

5 a. **Regulatory lag and the use of a historic test year do not establish a**
6 **sufficient basis for interim rates.**

7 The primary underpinning of the Company’s request for interim rates is the alleged financial
8 consequences to the Company of regulatory lag. The Company’s request deals only with non-fuel
9 costs, since the fuel adjustor mechanisms authorized by the Commission allow the Company to
10 recoup its fuel costs. *Id.* at 376-77. When questioned, Mr. Brandt agreed that, in the Company’s last
11 two rate cases, the Commission found that the Company was recovering its capital costs and that the
12 only increases that were necessary were for fuel. *Id.* at 276.

13 APS states that since its last case, it has made significant infrastructure additions which are
14 not yet recognized in rates and coupled with increasing material costs produce the net result that the
15 Company is experiencing a “financially crippling underearning.” (Ex. APS-1 at 4-5).

16 With filing rate cases on a historic test year basis and adjudicating them,
17 and whether it’s 15 months or 18 months, it’s a long period of time where
18 we’ve spent after the test year that Staff wants to ignore the capital
19 expenditures. Unfortunately, I don’t have that luxury, nor will Standard &
20 Poor’s ignore those capital expenditures and the interest that accrue as a
21 result of that.

22 (Tr. at 205).

23 If “you’re using a historic test year and we’re spending the level of capital expenditures that we are
24 on an annual basis, you never have a chance of earning an allowed rate of return.” *Id.* at 157.

25 But regulatory lag is an ordinary and anticipated feature of regulation. (Ex. S-1 at 12.) And,
26 the Company has considered only one side of the equation when it argues that regulatory lag is
27 preventing it from earning its authorized rate of return. The Company benefits from regulatory lag in
28 some ways as well, which Mr. Brandt has conceded. (Tr. at 154-55). One example of this is that the
Company continues to earn a return on plant that is retired or on accumulated depreciation or expired
amortization. *Id.*

1 Further, the \$1.7 billion in capital expenditures far exceeds the amount that will be reflected
2 in rate base. (Ex. S-1 at 12). When an offset is applied for accumulated depreciation, the amount that
3 will ultimately be rate based is significantly lower. *Id.* In addition, part of the \$1.7 billion in capital
4 expenditures, approximately \$297 million, is outside of the test year in the Company's pending
5 general rate case. *Id.* When all of this is taken into account, the amount of increase to APS'
6 jurisdictional rate base is more in the range of \$538 million. *Id.* at 12. Mr. Brandt conceded that
7 capital expenditures are offset by accumulated depreciation and deferred taxes to derive rate base.
8 (Tr. at 153-54). Further, he does not dispute Staff witness Smith's calculations. *Id.* at 154.

9 With respect to rate of return regulated entities such as APS, regulatory lag also provides an
10 incentive to the Company to control its costs which also impact its financial metrics:

11 The regulatory lag feature of Rate Base/Rate of Return regulation is
12 essential to effective and efficient operation of such a regulatory regime.
13 Because of the lag between placing new plant into service and obtaining
14 rate recognition of such plant, the utility may bear the cost of new plant
15 additions temporarily. This can encourage management to emphasize cost
16 control to a higher degree than might be expected if cost responsibility for
17 plant additions during the periods between rate cases were shifted away
18 from the utility and onto ratepayers. In evaluating plant additions, the
19 Company should conduct a cost-benefit analysis to determine if there is a
20 business case for implementing the plant additions on the time frame
21 budgeted by the Company. If the case is compelling and the project is
22 cost-justified, no additional special ratemaking treatment is needed. If the
23 project is not cost-justified or the benefits are too speculative to warrant
24 the commitment of funds, it may be prudent to delay or avoid the related
25 capital expenditures."

19 (Ex. S-1 at 13).

20 APS' capital expenditure ("CAPX") program for 2008 is over \$1 billion, and over the period
21 from 2008 through 2010, will be approximately \$3 billion. (APS Motion at 8-9). However, APS'
22 CAPX program is being reevaluated at the present time, so these numbers are likely to decrease.
23 Nonetheless, an article from Public Utilities Fortnightly on the 40 best energy companies in the
24 United States indicated that higher levels of CAPX spending would be the norm for the industry for
25 the foreseeable future. (Tr. at 471-72). The fact that management may have to bear the cost of new
26 plant additions temporarily, however, acts as an incentive to management to emphasize cost control.

27 APS also claims that the costs of that infrastructure are "spiraling upward on literally a
28 monthly basis." (APS Motion at 2). The Company points to raw material price increases from 2001

1 through 2008 for steel, aluminum, copper, gas and oil. *Id.* at 10. It states that copper and aluminum
2 are both significant distribution infrastructure costs. *Id.* But, as pointed out during the hearing, the
3 Company is recovering any increase in these costs through the end of 2005 (Tr. at 477). The cost
4 increases since 2005 will be addressed in its pending rate case.

5 Like its last case for rate relief, APS claims that revenues from customer growth are occurring
6 at an insufficient pace, absent periodic rate relief, to keep pace with the costs related to APS' capital
7 investment. (Ex. APS-1 at 5). But the investigation conducted by Staff in APS' last general rate case
8 concluded that there was no merit to APS' allegations that the cost of its customer growth exceeded
9 the revenues generated by that growth. (Ex. S-1 at 13). Decision No. 69663 states that "Staff's audit
10 of the company's current rates shows that the non-fuel costs are being recovered, contrary to APS'
11 claim that the cost of customer growth is greater than the revenues generated by that growth." *Id.* at
12 61.

13 Moreover, the Company acknowledges that its current and projected customer and demand
14 growth rates are reasonably comparable to prior years. (APS Motion at 9). And, it has most recently
15 stated that it is experiencing a slow-down in growth. (Tr. at 379). This is confirmed by the July 28,
16 2008 Moody's Credit Opinion for APS. That Report states that growth has slowed significantly
17 below the 4-5% level that the Company experienced in 2005 and 2006. In the First Quarter of 2008,
18 customer growth slowed to 2%, and Moody's stated that it was not expected to return to historic
19 levels over the near to mid-term. In addition, one of the Commission's recent decisions eliminated
20 the free footage allowance, which should bring in millions of dollars in cash flow for the Company.
21 S&P's Ratings Direct for February 14, 2008, stated the following:

22 The line extension ruling revokes the free footage allowance that APS
23 used to give customers. The change is expected to provide APS with
24 about \$50 million in incremental pre-tax cash in 2008 to offset some of the
25 company's distribution investment. Due to the rolloff of grandfather
26 provisions, this amount will approximately double in 2009. While the
27 ACC's ruling rejected the revenue accounting treatment sought by APS, it
28 regardless provides the company with an upfront source of cash for its
capital program, estimated to be in excess of \$1 billion in 2008. (For
details, see related article Arizona Public Service Co.'s Proposal To
Increase Cash Flow Through Unique Line Extension Policy Change
published Feb. 4, 2008, on Ratings Direct).

(Ex. S-4).

1 This ruling was also cited in Moody's July 28, 2008 APS Credit Opinion as very favorable. *Id.*

2 Finally with respect to APS' claims regarding its "worst earnings performance" in nearly two
3 decades, (APS' jurisdictional ROE for 2008 is anticipated to be just 8.4%. By 2009, the Company's
4 jurisdictional return falls to a meager 6.3%) (Ex. APS S-1 at 7), and PNW's lackluster stock
5 performance, these claims cannot be accepted at face value.

6 The reasons for PNW's poor stock performance may be due to other factors as well. Further,
7 it is important to note that from an accounting perspective the Company is recovering its costs. The
8 Company's costs are less than the sum of the prices that the company is charging its customers
9 because the Company is still earning a positive return on equity. (Tr. at 297). This is not to say that a
10 reasonable rate of return is not also a cost of doing business. But, the Company's projections with
11 respect to rates of return have not been the subject of any examination in this proceeding and may
12 include many expenses that would not be allowed for ratemaking purposes. (Tr. at 467). And, its
13 projections for 2009 and 2010 also do not include the impact of the increase in rates it is seeking in
14 its permanent case now pending before the Commission. In the words of the Attorney General:

15 Perhaps the only valid generalization on this subject is that interim rate
16 relief is not proper merely because a company's rate of return has, over a
17 period of time, deteriorated to the point that it is unreasonably low. In
18 other words, interim rate relief should not be made available to enable a
19 public service corporation to ignore its obligations to be aware of its
earnings position at all times and to make timely application for rate relief,
thus preserving its ability to render adequate service and to pay a
reasonable return to its investors.

20 To the extent that part of the poor performance is due to a claimed inability on APS' part to
21 earn its authorized rate of return, these claims should be evaluated in the Company's general rate case
22 as well as a more generic proceeding designed to examine the issue of the best and fairest ways to
23 address the impact of regulatory lag on APS and other Arizona utilities' with non-fuel costs.

24 **3. Using projected FFO/Debt Ratios as a basis for granting emergency rates**
25 **would create a slippery slope for future proceedings involving APS and**
26 **other utilities.**

26 The Company argues that the effects of regulatory lag are putting pressure on its FFO/Debt
27 ratio and that, as a result, it now faces the prospect of a downgrade by S&P to non-investment grade
28

1 level, which the Company claims carries a billion dollar price tag over the next 10 years. (Ex. APS-1
2 at 13). But, the Company's claims are not supported by the evidence in this case.

3 When asked, Mr. Smith stated that he did not have much experience with companies using
4 their financial ratios as a basis for obtaining interim relief. *Id.* at 629. Staff does not recommend that
5 the Commission use the FFO/Debt ratios as a basis for granting interim rates. Given all of the
6 uncertainties, basing the need for interim relief upon a company's FFO/Debt ratio would create a
7 slippery slope for the Commission with respect to any future applications. While relying upon the
8 FFO/Debt ratio as the basis for interim relief, APS witness Brandt opined that if the Commission
9 were to allow interim rates, it would still not reduce the Company's financial risk overall. (Tr. 160).
10 And, it should be pointed out that all the FFO/Debt ratios in this proceeding have been calculated by
11 APS, not S&P or the other credit rating agency analysts.

12 FFO/Debt ratios set by S&P are constantly fluctuating and any "blip" in performance can
13 send the ratio either in an upward or downward direction. In addition, as discussed below, the
14 Company's position is in large part based upon private conversations with S&P analysts which
15 cannot be verified by the Commission. The Commission should repudiate the use of these private
16 conversations as the basis for setting interim rates.

17 a. **APS is placing undue emphasis upon one S&P ratio to the**
18 **exclusion of the other quantitative and qualitative metrics used by**
the rating agencies.

19 There are three major credit rating agencies in the United States, S&P, Moody's and Fitch.
20 (Ex. S-3 at 3). Investment grade is defined as BBB (including BBB-) or above by S&P and Fitch. *Id.*
21 at 4. Moody's defines investment grade as "Aaa to Baa". *Id.* Ratings of less than triple-B are called
22 non-investment grade or "junk". *Id.* The agencies also employ 'outlook' indicators including:
23 negative, stable, positive and under review. *Id.* at 5.

24 Financial risk is analyzed both qualitatively and quantitatively. *Id.* at 6. Three financial ratios
25 are typically used as the basis underlying the agencies' quantitative analysis including: 1) FFO/Debt,
26 2) FFO/Interest and 3) Total debt/capital. *Id.* Business risk is analyzed qualitatively and for S&P
27 includes a review of the following factors: 1) regulation, 2) markets, 3) operations,
28 4) competitiveness, and 5) management. *Id.*

1 S&P does not use the financial guidelines exclusively in assigning ratings. In its November
2 30, 2007 Ratings Direct, the agency stated:

3 Note that even after we assign a company a business risk and financial
4 risk, the committee does not arrive by rote at a rating based on the matrix.
5 The matrix is a guide-it is not intended to convey precision in the ratings
6 process or reduce the decision to plotting intersections on a graph. Many
7 small positives and negatives that affect credit quality can lead a
8 committee to a different conclusion than what is indicated in the matrix.

7 *Id.*

8 Moody's and Fitch also consider both qualitative and quantitative risks in determining a
9 company's bond rating. *Id.* 7-9. The various factors for both Moody's and Fitch are set out on pages
10 7 through 9 of Staff witness Parcell's testimony. Thus, a myriad of factors are considered, including
11 among others, the regulatory environment, the risks the utility faces in its business, and the
12 performance of utility management. (Tr. at 278). The agencies also look at whether the financial
13 metrics are long term in nature or temporary. *Id.*

14 Staff witness Parcell commented on the importance of considering all three credit rating
15 agencies, and not just one:

16 First of all, there are three rating agencies, and there's a reason for that. If
17 there was only a need for one, there would only be one. ...

18 * * * * *

19 And I have heard it said that some of these agencies must – can only
20 invest in bonds that are investment grade by one or two agencies, not
21 necessarily all three. And some can only invest in bonds if they're
22 investment grade for all three. But again, it's different standards for
23 different people. So there are different agencies, and they have different
24 standards.

22 (Tr. at 899).

23 APS has the lowest investment grade rating with only one of the three agencies, S&P. (Ex. S-
24 2 at 3). The other two agencies, Moody's and Fitch, rate APS two steps above non-investment grade
25 at this time. *Id.* APS' Moody's rating is currently Baa2, and its Fitch rating is BBB. *Id.* at 9. In
26 addition, all of the agencies give APS a "stable" outlook. *Id.* at 10. The most recent change in this
27 regard occurred on July 25, 2008 when Moody's changed its outlook from negative to stable. *Id.*

1 On November 30, 2007, however, S&P changed its ratings system and designated all gas and
2 electric utilities as having a business risk profile as either strong or excellent, something that APS
3 witness Brandt failed to point out in his testimony. *Id.* at 288. For a company with a business risk
4 profile of strong and financial risk profile of aggressive, the ratings assigned to APS, the specified
5 FFO/Debt ratio falls now within a range of 10 to 30%. *Id.* Under the new guidelines, there are five
6 factors that are used in determining whether a utility possesses an excellent, strong, satisfactory,
7 weak, or vulnerable business risk profile. *Id.* at 344-45. Those are regulation, markets, operations,
8 competitiveness and management. *Id.* at 344. Moody's entire range for FFO/Debt is 13 to 25. *Id.* at
9 626.

10 Despite this, APS witness Brandt states that, even though S&P adopted new guidelines
11 applicable to utility ratings on November 30, 2007, APS still needs an FFO/Debt ratio of at least 18%
12 which was the standard under the old S&P guidelines for a business risk profile of "6." *Id.* at 79.
13 While Mr. Brandt states that the 18% is still applicable to APS, he could not cite to any published
14 S&P reports after November 30, 2007, which specify the 18% as still being applicable to APS. *Id.* at
15 365-71. He instead referred to a sentence on page 2 in S&P's November 30, 2007 RatingsDirect
16 which stated that the S&P utilities rating methodology remains unchanged. *Id.* at 366. But the
17 discussion under that refers to the five factors used to determine the business profile of the utility,
18 which have remained unchanged according to the report. *See* Ex. RUCO-3.

19 In fact, in response to questioning from ALJ Farmer, Mr. Brandt agreed that, S&P no longer
20 uses a business profile 1 through 10 ranking for utilities. *Id.* at 453. Mr. Brandt's reliance upon the
21 18% again is based upon his private conversations with S&P ratings analysts. *Id.* at 368.
22 "...[E]ffectively they do because S&P has 'told' APS that their minimum FFO/Debt ratio is 18%. *Id.*
23 at 453. Mr. Brandt further stated:

24 What the company has learned from the rating agencies, both through
25 statements made in the reports cited above and from discussions with
26 analysts, is that it is important for – excuse me--- it is important that APS
maintain an FFO-to-debt ratio within at least the 18 to 20 percent range to
stay within its current investment grade."

27 *Id.* at 91.

1 But, when asked twice if he thought S&P would be willing to state in writing that APS was
2 still subject to the old 18%-20% FFO/Debt threshold, he said "no". *Id.* at 498.

3 To be fair, the fact that APS was called out by S&P does raise questions as to whether or not
4 APS is going to be granted greater leeway in its FFO/Debt ratio by S&P simply because it was put
5 into the same category with all other utilities or whether S&P is going to continue to view APS as a
6 higher risk utility and look for higher credit metrics. And, while it is true that the new FFO/Debt ratio
7 parameters established by S&P have a much lower threshold starting at 10; the guidance S&P has
8 given in writing with respect to companies falling within the range was set out in Ex. RUCO-3:

9 ...the last sentence of that paragraph below that table, conversely a utility
10 that follows an atypical financial policy or manages its balance sheet less
11 conservatively or falls along the lower end of its business risk designation
would have to demonstrate an ability to achieve financial metrics along
more stringent ratio ranges to reach a given rating.

12 APS does not have an atypical financial policy for a regulated industry. Nor is Staff aware
13 that APS manages its balance sheet less conservatively. And, currently APS' financial metrics are
14 well within the ranges specified.

15 In fact, APS' FFO/Debt estimate for the end of 2008 is a ratio just shy of 21%. (Tr. 15 173).
16 Yet, Mr. Brandt testified that this is not good enough for two reasons. First, according to Mr. Brandt,
17 a good part of the increase from the prior year was due to a tax stimulus package that went into effect
18 which gave the Company a one-time depreciation bonus that improved its FFO/Debt ratio, and that
19 S&P would back this one-time occurrence out when considering the Company's year end FFO/Debt
20 ratio. *Id.* at 173-74. "The next year it deteriorates, and they know the reason it's as high as 20 percent
21 is because of the economic stimulus package. That's not sustainable. That's a one-time windfall."
22 *Id.* at 204. Second, he testified that it is not any one year that is important, but the FFO/Debt trend is
23 what is most important. *Id.* at 81. "Well, they don't look at the current year. They look at trends."
24 *Id.* at 204. Thus, again notwithstanding the absence of official statements to this effect, it is Mr.
25 Brandt's position that ratings agencies consider FFO/Debt on a trended basis, not on a current basis.
26 *Id.* So, essentially APS is saying that the current metrics do not mean much and that it could be at
27 18% and still be downgraded by S&P. Yet Mr. Brandt himself acknowledges that things can happen
28 which change the FFO/Debt ratio for any year, so any projected trend may in the end have very little

1 meaning. If trends truly are important, then S&P surely would consider that the Company has
2 general rate case pending which is scheduled to go to hearing on April 2, 2009.

3 AECC witness Higgins candidly admitted that his recommendations in this case are based
4 upon APS' representations regarding the importance of maintaining an FFO/Debt ratio of 18%. *Id.* at
5 279. Mr. Higgins stated that if the FFO/Debt would stay above 18% in 2009 without an interim rate
6 increase, or if he discovered that the 18% was no longer being used by S&P as APS represented, he
7 would reevaluate his position. *Id.* at 279-80. It is against this backdrop (the Company's
8 representations regarding likely S&P action if APS falls below 18% for this one credit metric) that
9 Mr. Higgins concluded that the Commission should take steps to prevent the FFO/Debt ratio from
10 going below 18 percent. *Id.* at 279.

11 Additionally, Mr. Smith pointed out, an official S&P report had put the Company's FFO/Debt
12 ratio at about 16% at year-end 2007. (Tr. at 618; Ex. S-1, attach. RCS-2 at 20, S&P Ratings Direct
13 6/25/2008: "Funds from operations (FFO) to total debt was about 16% at year-end, with FFO interest
14 coverage around 4x"). Further, despite all of the Company's statements regarding the need to
15 maintain an 18% FFO/Debt ratio, it recently acknowledged that the \$115 million would only produce
16 an FFO/Debt ratio of 17.6% in 2009, assuming no equity infusion. (Ex. APS-21).

17 c. **The written reports of the rating agencies do not suggest a**
18 **downgrade is imminent if the Company does not obtain interim**
19 **relief.**

20 Mr. Smith testified that he does not believe, based upon his review of the reports that there is
21 an imminent probability of a downgrade. (Tr. at 681). Mr. Parcel agreed. None of the reports
22 reviewed by Mr. Smith suggested that the Company is in any imminent risk of downgrade. *Id.* at
23 626-28. "We looked at a lot of credit rating agency reports, and I didn't see anywhere in there that
24 would start setting off alarm bells, at least to me as an analyst, saying that a downgrade is imminent."
25 *Id.* at 628.

26 In S&P's last report dated June 25, 2008, S&P acknowledged the use of a historical test year
27 in Arizona and that fully litigated rate cases take between 18 to 24 months to complete. (Ex. S-4).
28 S&P commented that this was expected to result in no meaningful improvement in financial

1 performance through 2009 and possibly beyond, depending on the timing and outcome of the
2 Company's current case. S&P also listed the Company's outlook as "stable."

3 The following explanation was included:

4 The stable outlook reflects our expectation that consolidated cash flow
5 volatility has been tamped down by the ACC's approval of a stronger PSA
6 that speeds recovery of fuel costs, but consolidated financial performance
7 will continue to be challenged by regulatory lag at APS, which could be
8 moderated by APS' pending interim rate request. The stable outlook is
9 premised on no meaningful adverse changes in the company's business
10 risks and continued financial performance that is not significantly weaker
11 than 2007 results. Equity issuances will be expected to balance the capital
12 structure of the company as APS continues to invest heavily in
13 infrastructure. Ratings could be lowered to speculative grade if the
14 company is not able to overcome the challenge of ensuring timely
15 recovery of its prudently incurred costs through rate increases approved by
16 the ACC. Given these challenges, and that presented by NRC scrutiny of
17 Palo Verde, we see little potential for positive movement in the ratings or
18 outlook.

19 (Ex. S-4).

20 The reports from both Moody's and Fitch are similar and do not contain any indication that
21 they intend to downgrade APS if its application for interim relief is denied. (Ex. S-4 and Ex. S-5).

22 With respect to financial metrics, Moody's had the following to say in its July 28, 2008 Credit
23 Opinion on APS:

24 In 2004 and 2005, APS' key financial metrics reflected the fact that it had
25 been unable to recover fully increased costs for fuel, purchased power and
26 capital spending on a timely basis. For example, the ratio of cash from
27 operations prior to changes in current assets and liabilities (CFO pre-
28 WC)/debt (incorporating Moody's standard analytic adjustments)
dropped into the mid-teens. Financial metrics improved in 2006 and 2007
with CFO pre- WC/debt moving to the upper -teens as fuel recovery
improved. These metrics are now toward the middle-to-upper end of the
13% to 25% range identified in Moody's Rating Methodology for Global
Electric Utilities for Baa rated entities on a stand-alone basis within the
medium risk category. Cash flow metrics are expected to remain in that
range over the near-to-medium term reflecting more timely cost recovery
of certain items and assuming capital expenditures are financed in a
manner that is also supportive of APS current financial strength and
flexibility. In general Moody's would look for APS to have financial
metrics that are somewhat stronger than comparably rated utility operating
companies that operate in regulatory environments that have historically
been more supportive of credit quality.

29 *Id.*

1 Fitch did say in its January 23, 2008 Credit Report for APS that attrition due to regulatory lag
2 could lead to deterioration in projected 2009 earnings and cash flows, resulting in credit rating
3 downgrades. But later in that same report Fitch stated the following:

4
5 Regulatory lag, combined with APS' large capital expenditure program, is
6 expected to result in lower operating profit, cash flow and credit metrics in
7 2008, with anticipated stabilization and modest improvement in 2009-
8 2010, in Fitch's opinion.

9 *Id.*

10 Staff witness Parcell also testified that "[i]t's apparent to me that the rating agencies have
11 recognized that this state's regulatory environment has and continues to improve from the standpoint
12 of APS. My reading of the rating agencies' reports cites this as a positive factor at the current time."
13 (Tr. at 894). *See* Ex. S-9. Mr. Parcell was referring to a February 2008 release by S&P which had
14 noted with favor several recent decisions of the Commission. (Ex. S-9). That release stated in part:

15 Standard & Poor's Ratings Services said that two rulings issued yesterday
16 by the Arizona Corporation Commission (ACC) are constructive in
17 delivering timely rate relief to Arizona Public Service, or APS (BBB-
18 /Stable/A-3).

19 In separate matters, the ACC approved a change in APS' line extension
20 policies and authorized the flow through to customers of an interim
21 transmission rate increase that was approved by the Federal Energy
22 Regulatory Commission (FERC) in 2007.

23 *Id.* at 1.

24 In summary, none of the rating agencies' reports indicate that absent interim rates there will
25 be an immediate downgrade to APS' credit rating.

26 **d. The Commission should not rely upon private conversations which**
27 **cannot be verified.**

28 APS relies almost exclusively on private conversations between Company CEO Donald
Brandt and S&P personnel for the proposition that a credit ratings downgrade is imminent in the
event no interim relief is forthcoming. Based upon these private conversations, APS CEO Brandt
puts the probability of a downgrade without interim relief somewhere between 75% and 100%. (Tr.
at 320). Mr. Brandt further stated, "the ratings agencies are going to make a decision in the very next
few months....[t]hey have told us very explicitly they will take it to their ratings committee for

1 consideration after the interim case is concluded.” *Id.* at 322. The outcome of the ratings committee
2 review will allegedly be a downgrade for APS if the interim rate increase is denied.

3 Mr. Brandt admitted to being privy to a lot of information and conversations that are not
4 available to the average investor. *Id.* at 372. “Well, first, your question, yes, I’m privy to a lot of
5 information that’s not generally publicly available, including our confidential discussions with the
6 ratings agencies that don’t get out.” *Id.* at 372-73. He also stated that a lot of the information
7 conveyed in these confidential meetings is relied upon by the rating agencies. *Id.* at 375. Staff asked
8 for summaries of these conversations in discovery, but APS did not provide them. *Id.* at 373-74.

9 As explained by Staff witness Smith, ratings reports are the official positions of each ratings
10 agency with regards to a Company. *Id.* at 628. “[T]heir official statements are their bond ratings
11 and the rationales that they use to rationalize those in their written report.” *Id.* Mr. Smith also
12 testified that he did not think it was common for the credit industry to see credit agencies saying one
13 thing in their reports but actually meaning something different. *Id.* at 628-29. “I think they try to be
14 as clear and transparent as possible.” *Id.* at 629. The danger of relying upon the statements of Mr.
15 Brandt is that they are not really verifiable. *Id.* It is like relying upon double or triple hearsay, and
16 there is no way to verify it. *Id.* The emphasis should be on the written reports. *Id.* at 629-30. Mr.
17 Brandt’s communications with S&P are clearly not the official position of the ratings agency.

18 Mr. Smith also testified that:

19 I think they are supposed to act in a manner that is suggested in their
20 written reports. And let’s keep in mind who their main – what they’re
21 supposed to be doing and who they’re supposed to be protecting. I mean,
22 they’re supposed to be protecting the bondholders. And, you know, I
really don’t think that they would take a drastic action of downgrading,
you know, a major company like APS to below investment grade debt
suddenly without giving them some further warning.

23 *Id.* at 639-40.

24 The written assessment of APS that S&P has provided in its ratings reports is the official
25 position of S&P and, it indicates a utility that has a “stable” outlook and a “strong” business profile
26 and an “aggressive” financial profile. (Ex. S-2 at 10, 12).

27 The only means by which the Company has proposed to dispel these concerns is interesting
28 but not practicable. APS’ witness Cicchetti suggested that commissioners could engage in the same

1 discussions with ratings agency personnel that Mr. Brandt has related through his testimony. (Tr. at
2 866-69). The suggestion is certainly direct but would not suffice to quell the problem. As has been
3 established by numerous cases in Arizona, decisions reached by the Commission must be founded on
4 a record that contains substantial evidence to support the ultimate decision. *Tucson Elec. Power Co.*
5 *v. Ariz. Corp. Comm'n*, 132 Ariz. 240, 243, 645 P.2d 231, 234 (1982). While it is a tantalizingly
6 simple solution to contemplate, it is unworkable as a means to supplement the absence of
7 documentary evidence that substantiates the oral communications Mr. Brandt has related that
8 contradict official positions articulated by credit rating agencies through their written reports.

9 e. **Staying above 18% FFO/Debt under S&P's Guidelines does not**
10 **guarantee that APS will not be downgraded and temporarily**
11 **falling below 18% does not mean that APS will be downgraded.**

12 APS witness Brandt characterizes the grant of interim rate relief as giving the Company a
13 cushion of protection against a downgrade to junk status. (Ex. APS-1 at 18). He further states that the
14 trade-off of denying that request is the significantly high risk that customers will have to bear higher
15 rates over the long-term if the Company is not able to stave off a downgrade to non-investment credit
16 ratings. *Id.*

17 Mr. Brandt also stated that granting the Company's interim rate request will likely allow APS
18 to circumvent the threat of a downgrade to junk during the course of the general rate proceedings. *Id.*
19 at 16-17. Conversely, staying slightly in excess of 18% does not guarantee that APS will stay
20 investment grade. (Tr. at 80). "[I]t doesn't take much of a blip in both operations or economic
21 circumstances out of our control in the future that could drive that down. And it could be instances as
22 I just said, events that are completely out of our control, that would drive it down." *Id.* at 80-81.

23 AECC Witness Higgins agreed, simply because you make an 18% FFO/Debt ratio is no
24 assurance that a downgrade will not occur. *Id.* at 266. APS could be above 18% and be downgraded.
25 *Id.* at 288. Moreover, if a company comes in under 18 percent, there is no assurance either that they
26 will be downgraded. *Id.* It would be only one factor that would be considered. *Id.* Moreover, any
27 number of unforeseen events could cause a downgrade. *Id.* at 288. "It is really a matter of looking at
28 probabilities and avoiding metrics that would increase the chances of a downgrade." *Id.*

1 Moreover, the downgrade that occurred back in December 2005 was from an investment
2 grade rating to a lower investment grade rating. The consequences of that downgrade were fairly
3 minimal, resulting in additional interest costs of \$1.25 to \$2.25 million per year. (Ex. S-1 at 24-25,
4 citing APS' response to Staff Interim 2.71(b); *see* also Ex. S-1, attach. RCS-2 at 31). If S&P were to
5 impose a further downgrade on APS, it would be from investment grade to non-investment grade,
6 which would have much greater and more devastating consequences for the Company in terms of its
7 access to capital and the cost associated with that capital, as explained by Mr. Smith in the above
8 passage. In such an event, it is likely that S&P would give the Company and its investors more of a
9 warning and change the outlook of the Company first before downgrading it to junk status.

10 S&P's unofficial position, as apparently expressed in secret communications with Mr. Brandt,
11 also stands in stark contrast with the positions of the other ratings agencies. For example, Moody's
12 recently upgraded the Company's profile from "negative" to "stable." (Ex. S-2 at 10-11; tr. at 893).
13 Both Fitch and Moody's place the Company's creditworthiness at two steps above junk grade. (Ex.
14 S-2 at 3). As elaborated upon by Mr. Parcell, against the context of two other ratings agencies that
15 rate the Company solidly above speculative grade, the notion that S&P would venture to reach a
16 rating assessment so significantly divergent from that reached by its peer agencies is highly unlikely.
17 (Tr. at 901).

18 Mr. Parcell stated in this regard:

19 Moody's just upgraded APS' outlook from negative to stable. This
20 was in July. So Moody's is pretty much on record being favorable toward
21 APS. And they are single - I'm talking about BBB middle or medium.

22 If S&P were to downgrade APS, there would suddenly be two ratings
23 below what Moody's has. That's not very common. They're usually all
24 in one park. Again, I don't see much prospects of Moody's going down.

25 So that raises a flag. I mean, does S&P care what Moody's does? I don't
26 know. But I think that S&P should care about being, for a company like
27 this, two ratings less than its rival at the same time because they - they
28 being S&P - just reaffirmed the stable rating.

Id.

1 D. The Company Is Not Facing An Undue Delay In The Processing Of Its General
2 Rate Case.

3 The Attorney General's Opinion also recognizes an exception to the need to find fair value
4 before implementing rates when the Commission is unable to grant permanent rate relief within a
5 reasonable time. In such circumstances, the Commission could implement interim rates. Op. Att'y
6 Gen. 71-17 at 13.

7 This case does not fall within that limited exception, however. While APS attempted to
8 portray a picture wherein the Commission takes an unusually long time compared to other
9 jurisdictions, Mr. Brandt conceded that, in some of those cases, APS itself had asked for additional
10 time, or the cases involved more than the standard issues considered in a typical rate case, and in one
11 instance, the case settled. (Tr. at 441-46).

12 In this case, the ALJ immediately established two separate procedural schedules; one for the
13 handling of the Company's emergency petition and the second for the handling of the Company's
14 permanent case. Significantly, there has been no suspension of the Company's permanent case while
15 its interim case is being addressed. The Commission continues to process both cases despite the
16 burden associated with processing two cases of this magnitude at once.

17 On July 29, 2008, a procedural schedule was established for APS' general rate case. The
18 procedural schedule provides for the filing of Staff and Intervenor direct testimony on December 19,
19 2008; APS rebuttal testimony on February 6, 2009; Staff and Intervenor Surrebuttal testimony on
20 March 6, 2009; and APS rejoinder testimony on March 20, 2009. A hearing on the Company's
21 request for permanent rates is scheduled to begin on April 2, 2009. An order by the Commission is
22 slated for October, 2009.

23 Thus, clearly, the *Mountain States Telephone* exception referenced in the Attorney General's
24 Opinion does not apply.

1 **E. The Company's Claim As To The Lack Of Alternatives To Address The**
2 **Company's Situation Will Depend On The Outcome Of The Current Financial**
3 **Crisis On Wall Street.**

4 One of the factors that the Commission considered in the Company's last case for emergency
5 rates was the availability of alternatives to address the Company's crisis. The Commission
6 recognized that, if there are alternatives available to address the Company's crisis, those factors
7 should be considered in determining whether there is a true "emergency." The Company's claim that
8 there are effectively no alternatives available should be met with some skepticism as the following
9 discussion illustrates.

10 APS claims that its internal generation of funds for needed infrastructure to serve customers is
11 anticipated to be 71% in 2008 and 60% for 2009, absent some interim rate relief. (APS Motion at 5.)
12 Thus it states that it has only two other options other than a rate increase: new equity or new debt
13 issuances. The record demonstrates that it can also take other measures, such as reducing its costs, as
14 well.

15 **1. An equity infusion may be possible in 2009.**

16 The Commission recently authorized PNW to infuse up to \$400 million of equity into APS,
17 but any such infusion must be made on or before December 31, 2009. Decision No. 70454 at 4.
18 Staff originally recommended that the Company's receipt of interim rate relief be contingent upon
19 PNW making the equity infusion. (Ex. S-1 at 40). At the hearing on this matter, however, Staff
20 witness Smith revised his recommendation so that any grant of interim rate relief would no longer be
21 contingent upon PNW issuing equity and infusing it into APS. (Tr. at 615-16). This change in Mr.
22 Smith's position was based in part on Mr. Brandt's testimony at the hearing that the markets currently
23 are not in a state that would support an equity issuance by the parent company, PNW. *Id.* at 621. Mr.
24 Brandt testified that in 2008 the equity markets all but dried up for electric utilities. *Id.* at 66, 67. He
25 further testified that the events of the last few weeks would make the situation even worse. *Id.* at
26 391. The year 2009 would be the earliest that PNW could make the infusion. *Id.* at 391.

27 Mr. Smith also agreed that, if the Company can avoid issuing stock below net book value, it
28 would be better. *Id.* at 621. PNW's stock was slightly below book when the Company filed its

1 application for Commission approval of the up to \$400 million equity infusion. *Id.* at 169. "...but at
2 March 31st the book value of the stock was at 99.6 percent of book value and as of last week it was at
3 92 percent. *Id.* The day of the Open Meeting on the equity infusion it was 86% of book value. *Id.* at
4 412. He further testified at the hearing that, once he informed PNW's three largest equity holders,
5 Franklin Investments, Capital Research and T Rowe Price, that PNW would not infuse equity in
6 2008, its stock went up 15% relative to the utility group as a whole. *Id.* at 68-69.

7 Whether or not the equity issuance occurs will affect the Company's FFO/Debt ratio and
8 therefore could impact the amount of interim rates. *Id.* at 622. According to Mr. Brandt, an infusion
9 of the amount sought by APS would amount to approximately a two percent increase in its FFO/Debt
10 ratio. *Id.* at 392. However during the hearing, the Company appeared to back away from any
11 suggestion that equity should be used to improve the Company's financial metrics. (Tr. at 538).
12 Company witness Brandt himself acknowledged that the Company sought approval for PNW to make
13 the investment to maintain investment grade credit ratings and to improve financial stability. *Id.* at
14 164. This is also consistent with the APS Request for Interim Rates.

15 Witness Brandt testified that another internal effort to prevent a downgrade to junk was
16 PNW's infusion of \$460 million of additional equity into APS during 2005 and 2006. (Ex. APS-1 at
17 14). According to Witness Brandt, this resulted in an improvement in the Company's key FFO/Debt
18 ratio to the extent possible during tense financial times. *Id.* But the \$460 million infusion in 2006
19 consisted of only \$250 million in common stock. The remainder was from the sale of the Silverhawk
20 Power Plant that was held by Pinnacle West Energy Company. (Tr. at 392).

21 Moreover, the interrelationship is borne out by other evidence in the record. A Bank of
22 America equity research department publication dated August 4, 2008 states that with the reduction
23 in capital spending, Pinnacle West stated that the possibility of equity issuance can be deferred. *Id.* at
24 334). The publication states that "[W]e expect Pinnacle West and Arizona Public Service to utilize
25 its short-term borrowing to fill its financial needs in 2008." And it also states, "we believe that equity
26 issuance will not be necessary until FY10." *Id.*

27 According to the Company's four point plan which it outlined to the credit agencies, whether
28 or not the Company will issue equity in 2009 depends upon the interim rate case, how the general rate

1 case proceeds, and the Company's ability to reduce its CAPX budget. In describing the plan, Mr.
2 Brandt referred to remarks by Greg Gordon of CitiGroup during an earnings call:

3 ...but as you think about the capital formation plans, you are not going to
4 issue equity in '08, and depending on the level of interim rate relief and
5 how you're feeling about the progress of the GRC in conjunction with
6 how well you do in meeting or beating your CAPEX reduction targets,
7 equity may or may not actually be needed in '09.

8 *Id.* at 408.

9 Company witness Brandt next maintained that even with an equity infusion, the APS
10 FFO/Debt ratio would subsist within investment range for only a short time – until mid-to-late 2009,
11 at which time it would fall to junk, according to Brandt. (Ex. APS-1 at 14). But Mr. Brandt's
12 prediction is at odds with information given by APS to Staff witness Smith in response to a Staff data
13 request. In response to Staff Interim 2.59, APS provided the following FFO/Debt trend based on the
14 assumptions of no interim increase, an equity infusion, and the Company's receipt of 50% of its base
15 rate increase with rates effective October 1, 2009: APS' FFO/Debt ratio is expected to be 23% in
16 2008, 18.7% in 2009 and 18.5% in 2010. (Ex. S-1 at 20).

17 The amount recommended by Mr. Higgins for an interim increase of \$42.4 million presumes,
18 that the Company would make an equity infusion of \$400 million in 2008. *Id.* Interestingly, even
19 though Mr. Brandt stated that APS will not be making any equity infusion in 2008, AECC witness
20 Higgins made clear that his recommendation of \$42.5 million would not change. *Id.*

21 I want to be clear that I am not recommending more than \$42.4 million. I
22 do believe that APS should have the latitude to decide when the most
23 propitious moment is for the Company to infuse that equity and to go to
24 the capital markets for additional equity. And I think that my
25 recommendation is that it ought to be left to them to weigh those factors
26 going forward and to act in the best financial interest of the company and,
27 therefore, customers with respect to issuing that new equity.”

28 *Id.* at 269.

When asked what he would recommend if the amount were insufficient to maintain an
FFO/Debt ratio of 18.25%, as of the end of 2009 he stated:

1 A. I think the Commission would want to understand what factors
2 were contributing to that. And, for example, if the primary factor
3 was that APS had not issued new equity, then I believe that the
4 Commission may, you know, at some point want APS to fully
 explain why it wasn't issuing new equity in light of the fact that
 the company had been awarded an interim rate increase and was
 still projected to have an FFO to debt ratio under 18 percent.

5 *Id.* at 273.

6 Ultimately, Staff agrees with APS that an equity infusion of up to \$400 million, which was
7 approved in Decision No. 70454, will not be feasible in 2008. Whether APS and its parent, PNW, are
8 able to do this in 2009 will depend upon market conditions and management's evaluation of the
9 situation. It is also clear that the FFO/Debt ratio for APS is impacted by a number of factors,
10 including APS' level of capital expenditures and methods of financing (debt or equity) such
11 expenditures. In Docket No. E-01345A-08-0228, APS indicated to the Commission that the
12 requested equity investment was necessary to allow APS to maintain its current investment grade
13 credit and to improve its financial stability. With an equity infusion, and assuming various levels of
14 rate increases in APS' general rate case effective in late 2009, APS' FFO/Debt ratios appear good.
15 (Ex. S-1 at 20).

16 If other assumptions are made, the results are different. With APS' announced capital
17 expenditure reductions, Mr. Brandt testified that the projected FFO/Debt ratio for 2009 is 18.3% with
18 an equity infusion and 16.4% without one. *Id.* at 488. Thus, if market conditions improve in 2009, it
19 may behoove APS and PNW management to proceed with equity infusion. This discussion, however,
20 hopefully also illustrates the futility of attempting to tie any interim rate increase to maintenance of
21 an 18% FFO/Debt ratio.

22 **2. Reduction to Operating and Maintenance ("O&M") and Capital**
23 **Expenditures ("CAPX") will have their greatest impact in 2010 and 2011.**

24 In its application for equity infusion, the Company stated that APS expects to have a cash
25 flow shortfall of roughly \$400 million caused by the difference between funds received from
26 operations and the Company's extensive capital needs. *Id.* at 493. The Company has begun to take
27 measures to reduce its CAPX spending. Through the latter half of last year into the first quarter of
28 this year, the Company streamlined operations and consolidated distribution and transmission under
one individual. *Id.* at 115. In connection with that, the Company eliminated \$200 million of capital

1 expenditures. *Id.* It also eliminated \$14 million of operating and maintenance costs. *Id.* The
2 Company is now in the process of cutting its CAPX budget by \$500 million or more. *Id.* at 116.

3 However, when questioned about the impact of these CAPX reductions on the Company's
4 FFO/Debt ratio, Mr. Brandt testified that the reductions would somewhat impact 2009, but would be
5 heavily loaded towards the 2010 and 2011 timeframe. *Id.* at 126. Further, when asked whether this
6 might forestall the need for an interim rate increase, Mr. Brandt stated that there is nothing that the
7 Company can do to forestall that need. *Id.* at 128. When asked if further CAPX reductions may
8 result if the Company does not get all of its requested interim relief, Company witness Brandt stated
9 "that would depend on the nature and extend of the relief granted." (Tr. at 588). A slowing economy
10 and slower growth should allow APS to reduce O&M and capital expenditures, thus helping APS'
11 cash flow and alleviating some of the financial pressure during the pendency of APS' current general
12 rate case.

13 **3. The Company has credit lines available that go through 2010 and is not in**
14 **a financial emergency during the pendency of its general rate case.**

15 As explained above, the Company argues that it simply cannot issue new equity in the current
16 market; therefore, its only resort is new debt and additional funds provided by ratepayers. The cost of
17 any new debt is dependent upon its bond ratings. Mr. Brandt testified that APS no longer has ready
18 access to the commercial paper markets. *Id.* at 515. While APS had difficulty issuing commercial
19 paper in 2007 and 2008, APS was able to obtain short term borrowings under its revolving credit
20 facilities, which had similar pricing to commercial paper. (Ex. S-1 at 27-28; also Ex. S-1, attach.
21 RCS-2 at 34). APS has bank credit facilities in place that go through 2010 (about 900 million). (Tr.
22 at 515). APS' debt authorization ceiling was increased to \$4.2 billion. (Tr. at 530; Decision No.
23 69947).

24 If the Company's bond ratings are lowered to "junk" or "non-investment" grade status, it is
25 true that the Company will have a much more difficult time getting access to capital. And, once APS
26 does get access to capital, any borrowings would be much more expensive for ratepayers. (Ex. APS-
27 1 at 11).

28 As to APS' ability to access debt, Staff witness Parcell explained:

1 Well, it would have some effect because, again, some people couldn't buy
2 the debt because one agency was below investment grade. So if there's
3 less demand and the same supply, the price is going to go up. So there
4 would be some effect. How much? It's hard to say, especially if you have
got two rating agencies—that are two rating categories higher. So, you
know there would be some effect, but I don't think anyone could actually
tell you how much it would be.

5 (Tr. at 902).

6 CEO Brandt hypothesizes that if the Company goes to junk, it will remain there for at least 5
7 years. *Id.* 502-503. Mr. Brandt claims that the cost to ratepayers over the next ten years will be
8 approximately \$1 billion, or \$70 million to \$145 million per year by 2019. *Id.* at 513. He has
9 calculated the \$1 billion in additional financing costs as if the Company will be in junk status for 10
10 years, however. He claims that this is equivalent to a 2.7% to 5.5 % increase to customers for each
11 year that the Company remains non-investment grade. *Id.*

12 It is this \$1 billion that forms the basis for the Company's challenge to everyone, including
13 the Commission: "Do you want to take a \$1 billion gamble that the Company will not be
14 downgraded to junk status?" As discussed earlier, using FFO/Debt ratios as a basis for setting
15 interim rates will deteriorate into this sort of "roll of the dice" type of analysis which is very simply a
16 poor and unreliable substitute for the traditional analysis typically performed by the Commission in
17 determining whether interim rates are appropriate.

18 In summary, the Company's has credit lines that go through 2010 and there is no financial
19 emergency in this regard through the pendency of its general rate case. While Staff agrees that the
20 current Wall Street crisis has cast a pall of uncertainty over this case, Staff believes that it is too early
21 to predict the outcome of that event.

22 **F. Staff's Alternative Recommendation.**

23 At most, with the Wall Street meltdown, an impending emergency may exist which may
24 justify some interim relief. Staff has put forward an alternative recommendation in this case in the
25 event the Commission found that some interim relief was necessary in this case. That alternative is
26 not related to the Company's controversial and constantly fluctuating FFO/Debt ratio. Staff's
27 alternative recommendation is based upon the net change in rate base, which includes plant additions,
28 changes in accumulated depreciation, and several other items that comprise rate base. *Id.* at 681. It is

1 limited to the change in jurisdictional rate base up to the end of the 2007 test year in the Company's
2 permanent rate case. *Id.*

3 In Decision No. 69663, the Commission determined that APS' jurisdictional adjusted original
4 cost rate base was \$4.403 billion. In the current rate case, APS' filing at Schedule B-1, page 1,
5 Column D, shows an unadjusted jurisdictional rate base of \$4.941 billion. Based on the change in
6 jurisdictional rate base from Decision No. 69663 through the end of the test year, this is an increase
7 of approximately \$538 million. (Ex. S-1 at 34). In accordance with the \$538 million jurisdictional
8 rate base increase, Staff recommends an interim increase in the amount of \$65.2 million, effective
9 with the first billing cycle in November 2008. *Id.* at 37, *also see* Ex. S-1, attach. RCS-4. For
10 comparative purposes, the \$65 million would represent approximately 56.5% of the \$115 million
11 interim rate increase requested by APS.

12 APS attacked the Staff's proposal as not going far enough. (Ex. APS-2 at 38). APS did its
13 own calculation using aggregate plant numbers, but conceded that much of that was post test year.
14 (Tr. at 462-63). First, the Company added what it believes to be the increased book depreciation of
15 \$30 million to Mr. Smith's \$65 million to obtain a figure of \$95 million. *Id.* at 462. Adding post test
16 year plant for 2008 would add \$49 million, and with projections of capital additions in 2009, that
17 number would increase by an additional \$72 million, which brings the total claimed by APS to \$167
18 million. *Id.* at 464. The Company's chart showed the revenue requirement of \$167 million for year-
19 end 2008, and it increases to \$247 million at year-end 2009. *Id.* at 507. When questioned further by
20 ALJ Farmer, Mr. Brandt conceded that none of these plant additions had yet been found to be
21 prudent, nor have any expenses (including depreciation) been analyzed for regulatory purposes. *Id.* at
22 464-67. He conceded also that some of the plant expenditures have not yet even been made.

23 Mr. Smith testified that awarding rate relief beyond the \$65 million becomes problematic
24 because Staff has not yet sorted out the pro forma adjustments in the Company's income statement.
25 *Id.* at 619. Thus, going beyond the pretax return on rate base involves potentially getting into the
26 controversy of sorting out income statement items, including revenue growth. *Id.* at 620. Going
27 beyond the test year for plant additions into 2008 and 2009 is another area of controversy and should
28 not be the basis for an interim rate increase, in Staff's opinion. *Id.*

1 Staff witness Smith stated in this regard:

2 We had concerns because it didn't reflect other changes in the income
3 statement, including additional revenues. So it looked to me from my
4 initial review of the company's general rate case application that there was
5 a lot going on in the income statement, and we haven't sorted that out.
We think to incorporate an additional item related to the income statement
fluctuations would potentially get into controversial areas that are going to
be addressed in the rate case.

6 *Id.* 678.

7 Witness Smith also stated:

8 And there's some change in revenue from customer growth from
9 September 2005 through December 31, 07. So we're not trying to capture
10 either of those. We're just strictly focusing on the change in net
11 jurisdictional rate base and applying what is, in essence, a pretax cost of
12 capital using that cost of capital that was approved in the company's last
13 rate case to derive the amount.

14 We thought that going beyond that wasn't appropriate at this time for this,
15 for an interim rate increase. We wanted to tie it to something tangible in
16 the rate case that was known and measurable that appeared to be within
17 the Commission's standards for determining a base rate revenue
18 requirement, and that's basically how we derived the 65 million.

15 *Id.* 679.

16 Staff's alternative proposal is over \$20 million above AECC's proposal of \$42.2 million,
17 which was originally based on APS' FFO/Debt ratio. APS opposes both the Staff's alternative
18 recommendation and AECC's proposal. *Id.* at 83. Mr. Brandt testified that both proposals would be
19 "cutting it way too close," and AECC's number assumes that equity would be issued. *Id.* According
20 to APS, without the equity issuance, the Company would need \$166 million to reach the 18.25% in
21 2009 upon which AECC's proposal was based. *Id.* at 554-55. Interestingly, the FFO/Debt ratio
22 produced by the Company's own recommended \$115 million would also result in an FFO/Debt ratio
23 below 18% in 2009, without an equity infusion. (Ex. APS-21).

24 The need for \$115 million to avoid a downgrade, the position urged by APS, is not borne out
25 by the views of the investment community. A publication by Bank of America's equity research
26 department dated August 4, 2008 does not anticipate that APS will receive its full interim request but
27 only 75% of it, and it has a rating of neutral for the Company. (Ex. S-3.)

28

1 When asked if there would be a downgrade if the Company received interim relief in the
2 amount recommended by AECC or Staff, Mr. Brandt stated that he had not thought that through yet.
3 (Tr. at 486). But APS witness Cicchetti appeared to suggest that, in his opinion, while a downgrade
4 was certain if no interim relief was granted, as long as some interim relief was granted, it was his
5 opinion that there would be no downgrade. *Id.* at 841-42.

6 AECC witness Higgins' position on the Company's request for \$115 is reflected in the
7 following exchange at the hearing on this matter:

8 Q. Would granting \$115 million of interim rates be reasonable in this
9 case?

10 A. In my opinion it is more than is needed for interim relief. And so I
do not believe that's reasonable.

11 Q. Would it be warranted in this case?

12 A. I do not believe it is warranted.

13 Q. Would it be prudent in this case?

14 A. I do not believe it is necessary to prudently protect the utility's
15 financial health.

16 *Id.* at 276.

17 In sum, if the Commission determines that action is necessary to avert an impending
18 emergency, Staff's alternative recommendation offers a reasonable solution.

19 **G. There Is Sufficient Evidence In The Record To Determine A Fair Value Finding**
20 **In the Event the Commission Believes that Interim Relief is Necessary .**

21 There is sufficient evidence in the interim rate hearing testimony and record from which to
22 determine a fair value finding. In APS' last rate case, Docket No. E-01345A-05-0816 et al, the
23 Commission found a fair value rate base at September 30, 2005 of \$6,057,554.000. *See* Decision No.
24 69663 at 15. It appears that APS' ACC jurisdictional rate base at original cost has grown by
25 approximately \$538 million from Decision No. 69663 through the end of the test year, December 31,
26 2007, in the current APS general rate case. (*See, e.g.,* Ex. S-1 at 34). Because the change in rate base
27 from Docket No. E-01345A-05-0816 et al to December 31, 2007, the end of the test year in the
28 current APS general rate case is primarily attributable to changes in net plant (gross plant less

1 accumulated depreciation), and the changes in plant relate to recent additions, the amount of rate base
2 growth at original cost could be used as an approximation of the growth in fair value rate base. If a
3 finding of fair value is necessary for purposes of granting an interim rate increase, the \$538 million
4 could be added to the \$6,058 billion from Decision No. 69663 to arrive at an approximate fair value
5 finding at December 31, 2007 of \$6,596 billion. If the Commission chooses to grant an interim rate
6 increase, this finding of a fair value could be used. The change in jurisdictional rate base at the
7 currently authorized cost of capital, would produce an interim rate increase of approximately \$65.2
8 million. Computing the interim rate increase in this matter would also help assure that an excessive
9 return is not being provided APS.

10 **H. The Appropriate Rate Design For An Interim Rate Increase Is A Policy Decision**
11 **For The Commission And Staff Recommends A Cents Per kWh Approach.**

12 The general principle of rate design is normally used to fairly account for costs. The same
13 principle for rate design for permanent rates cannot be applied to interim rates. This is because there
14 is not a complete record as to cost causation that would be present in a permanent rate case.
15 Therefore, the Commission must establish a fair and equitable way to distribute any interim rate
16 increase that is determined to be appropriate. (Tr. at 290-91).

17 APS has proposed three different rate designs for implementing the interim rate surcharge.
18 The three methods are: a) assess the surcharge on a per kWh basis similar to the Interim PSA
19 Adjuster; b) assess the surcharge as percentage adder to base bills using an equal percentage increase
20 for all customers; or c) assess the surcharge revenue requirements to customer classes on a per kWh
21 basis but recover the resulting revenue requirements on a demand basis from general service
22 customers whose base rates include demand charges. *Id.* If the Commission decides to grant interim
23 rate relief, Staff recommends that the surcharge be based on an equal cents per kWh charge for all
24 affected customers. (Ex. S-1 at 42).

25 AECC proposed that the interim increase be assessed on a percentage basis, with the same
26 percentage applied to all customer classes. (Ex. AECC-1 at 8). AECC argues an that equal cents per
27 kWh approach would negatively impact customers with higher load factors. (Ex. AECC-1 at 8). On
28

1 the other hand, the percentage-across-the-board method raises the bills of residential customers and
2 small general service customers more than a cents-per-kWh approach. (Ex. APS-18 at 3).

3 Staff has tried to balance the interests of all interested parties and come up with a
4 recommendation that takes into account the interests of all parties. (Tr. at 651). Mr. Rumolo stated
5 that “under the cents per kWh basis it is the same charge for everyone, so if a particular class’
6 consumption is 60 percent of the total, they would pay 60 percent of the charge.” *Id.* at 1037. He
7 then later stated that “[o]n a percentage basis, the largest load factor customers would pay a lower
8 proportion of the proposed \$115 million. On a kilowatt hour charge, it would be directly
9 proportional.” *Id.* at 1039.

10 APS has stated that it has no preference as to which method is ultimately used and believes
11 that each of the approaches would be equally simple to implement, administer, and track should there
12 be a need to make refunds in the future. (Ex. APS-19 at 8). APS witness David Rumolo stated that
13 “...all three methods could be described as fair. We know that our rates don’t exactly track cost of
14 service on a regular basis. So it is inherent in ratemaking that rates may not track cost of service
15 exactly.” (Tr. at 1040). Additionally, he stated that “...any methods are acceptable to us. They all
16 have some plusses and minuses depending on your perspective....” *Id.* at 1011. Therefore, the
17 Company has made it clear that it has no preference among the three methods that it has proposed.

18 Ultimately, it is a policy decision for the Commission to determine which approach to use in
19 implementing interim rates. APS also believes that it is a decision for the Commission to make. Mr.
20 Rumolo stated that he thought it was a policy decision in this case. *Id.* at 1040. Additionally, Staff
21 has made it known that, as a policy, it recommends interim rate relief based on a kWh basis. As a
22 matter of policy in this matter, Staff favors a cents per kilowatt based interim surcharge, if there is
23 one. Staff witness Ralph Smith stated that “...Staff is concerned about the impact on customers who
24 have the least ability to pay. And a cents per kilowatt hour rate design would provide some slight
25 benefit to the smaller customers, and that’s the policy reason why Staff favors that rate design
26 alternative.” *Id.* at 620-21.

27 Additionally, APS proposed that customers who receive service under the low-income and
28 medical equipment rate schedules (Schedules E-3, and E-4) should not be charged the Interim Base

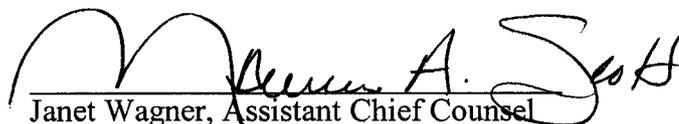
1 Rate Surcharge under any of the rate design alternatives since those customers are exempt from the
2 PSA adjustor. (Ex. APS-18 at 2). There does not seem to be a disagreement by any party about this
3 matter. AECC Witness Higgins and Staff Witness Smith both agreed that Schedule E-3 and E-4
4 customers should be exempt from any interim rate increase. (Transcript, Vol. II, pg. 229, lines 7-10,
5 (Tr. at 229, 620).

6 If the Commission determines that an interim rate increase is warranted, Staff recommends a
7 rate design in the form of an equal cents per kWh approach. Lastly, Staff agrees with APS that E-3
8 and E-4 customers should be exempt from any interim rate increase.

9 **IV. CONCLUSION.**

10 Staff does not believe that the Company has demonstrated circumstances that would justify
11 interim rates. Staff, however, acknowledges the uncertainty created by the current financial market.
12 As stated in Decision No. 68685, the Commission's "authority to determine emergencies is not
13 limited to specific narrowly tailored facts, and is sufficiently broad to enable us to grant relief tailored
14 to many different situations." Staff believes that the Commission could implement interim rates if it
15 found that, absent action at this time, an emergency or crisis is likely to occur, and the Commission
16 found some measure of fair value in its order authorizing interim rates. It stands to reason that
17 Arizona law would recognize that the Commission should not have to stand back and wait for an
18 actual emergency to occur prior to taking some action to avert an impending crisis which could have
19 a significant adverse impact on rates.

20 RESPECTFULLY SUBMITTED this 3rd day of October, 2008.

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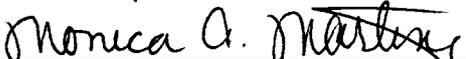
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